BALANCING ACT

Nikko AM Multi-Asset's global research views

Snapshot

Macron is the next President of France – finally, a win for the establishment. Macron took 66% of the votes over Le Pen's 33%, but is this a mandate against populism? We do not think so, as the disenfranchised class is already formidable and will only continue to grow until there is, in fact, change or the establishment is fully toppled. However, it at least offers some near-term market relief. Macron understands this and, while his promise to bring the country back together is encouraging, the devil is always in the details and the execution risk is daunting. The French election result scores one for the establishment, but long-term relief is still pending election outcomes in Germany this fall and Italy in early 2018. The latter presents the biggest risk given the local strength of the populist movement.

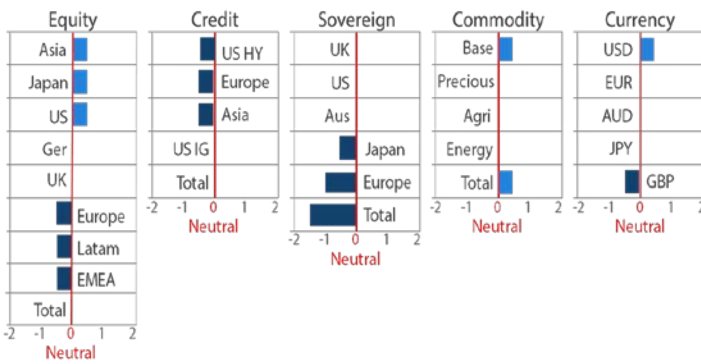
Markets cheered the first-round result of the French presidential election in late April as it was, at that point, clear that Macron would most likely win the second round to become President of France. Strong earnings and top line growth around the world added to the sense of euphoria. Less noticed were the headwinds coming from China's credit tightening, which was reflected in local markets and more broadly in commodity weakness. China is leaning back to reform – which is a good thing – and taking aim at shadow banking to force speculative deleveraging. This is at least partly responsible for the decline in commodities. The deleveraging will likely run its course and leave reflation largely unaffected, but caution is warranted given the potential knock-on effects as China demand and commodity prices continue to nudge weaker.

Leadership in China is likely emboldened to keep the regulatory squeeze on following strong first quarter growth of 6.9%, which was above the 6.5% target for 2017. How long will this tightening last? It is hard to say given that there are no stated targets. However if the 18th Party Congress in 2012 is any guide, we might expect liquidity injections by August/September, ahead of the 19th Party Congress to be held in October/November 2017. For the moment, tightening can be expected to grind on. Currencies of commodity exporters are already in decline and given the high levels of dollar debt, the risk is another bout of deleveraging and a potential stall or reversal in emerging market (EM) portfolio flows. This is not our base case, but is nevertheless a risk to closely monitor.

On the other side of the Pacific, the US reflation trade appeared to have stalled with first quarter GDP growth clocking a measly 0.7%, its weakest rate in three years. This perceived soft patch was a clear setback to the Trump reflation trade where it was hoped animal spirits would boost demand. However confidence levels remained high, giving credence to the alternative narrative that the disappointment was mainly due to seasonality. In recent years, first quarter growth has been habitually weak, followed by upward adjustments and stronger numbers later in the year. With strong top line growth and profits, we worry less about US growth stumbling from here, particularly as Trump moves closer to executing on at least some elements of his tax reform and infrastructure agenda.

Overall, despite pockets of slowing demand, we see the reflation trade remaining intact because of its broad and synchronised nature. Now even the previously lagging EMs and Europe have been included. Commodities may continue to feel headwinds over the near-term, but ultimately the supply side adjustment, including an OPEC commitment on the oil side, along with growing global demand should allow the complex to find support.

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

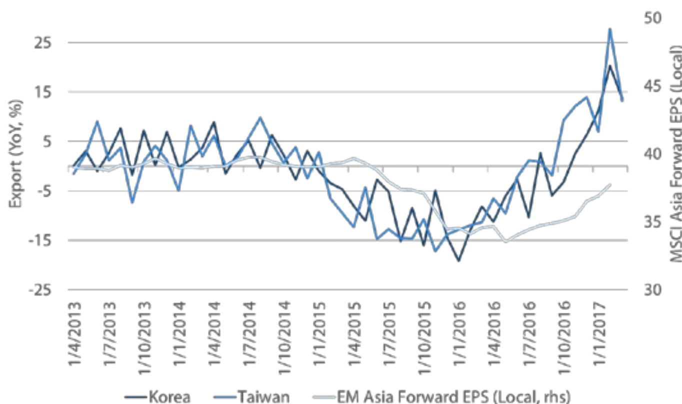
Asia bumps the US off the top spot

This month we lift Asian equities above the US on our equities asset class hierarchy. Our research process has been suggesting similar levels of attractiveness for Japan, Asia ex Japan (AxJ) and the US for the last few months. This remains the case this month as well.

Asian equities continue to rank higher on valuation than the more expensive US equity market, while the macro scores remain tilted in favour of the US. However the macro outlook has been improving more recently in Asia, particularly on corporate earnings and liquidity.

As shown in Chart 1, strengthening global demand (ex-China) is translating into stronger earnings momentum in the export oriented markets of Korea and Taiwan.

Chart 1: Asian earnings momentum



Source: Bloomberg, 2017

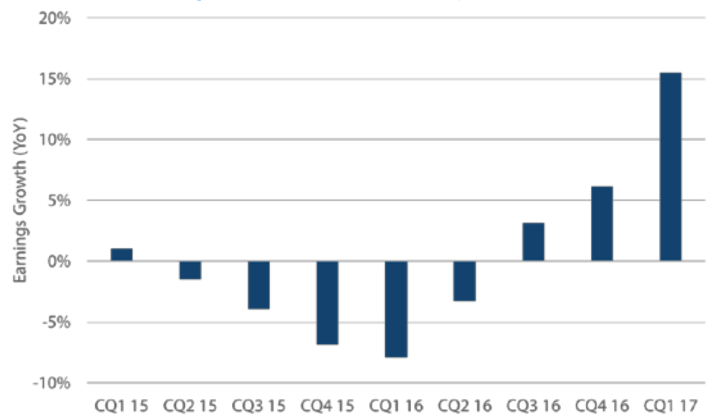
Korea and Taiwan are both key beneficiaries of the structural increase in demand across the Technology sector. This is in turn being driven by strong demand growth in businesses related to cloud computing and connected devices or the Internet of Things (IoT).

There are also signs that industrial profit growth in China is now driving increased consumption demand. Southeast Asia is a key beneficiary. Consumption and demand growth remain strong in India too.

Unlike the broad EM economies, Asia is an importer of commodities and is therefore less exposed to commodity weakness. High savings rates and fiscal reforms have allowed most of the region to remain buffered against external weakness via fiscal investment in infrastructure. Banks remain the weak link and an impediment to private investment, but we also see improvements there as Thailand's non-performing loans (NPLs) have peaked and as India takes aim to recapitalise ailing State banks. All of the above augur well for continued growth in Asian earnings.

At the same time we should note that our bull case for US equities too was predicated around an expected earnings turnaround. As shown in Chart 2, this has largely panned out as expected. From here onwards however, any deceleration in the earnings growth trajectory is more than likely to lead to consolidation given the extended valuations. Of course, the likelihood of any earnings disappointment depends largely on the progress of the legislative agenda. As mentioned in the introduction, we remain optimistic on the prospects of both tax reform and infrastructure. However risks of delay have grown more recently.

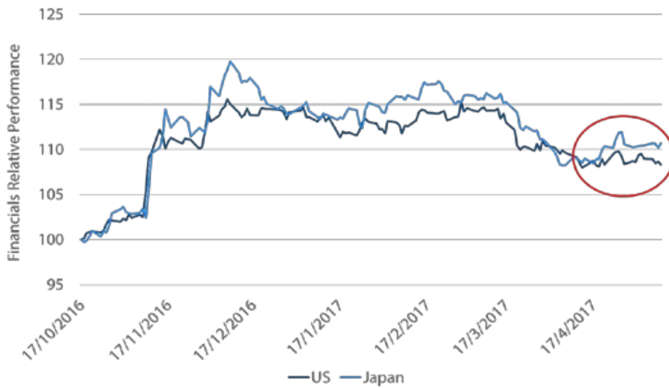
Chart 2: US earnings have recovered as expected



Source: Bloomberg, 2017

Aside from the earnings outlook, we would note that liquidity is another macro factor supporting the shift in preference for Japan over the US. Liquidity and financial conditions remain very easy in the US. However the delta in liquidity conditions appears to be a stronger tailwind in Japan than in the US. The performance of stocks in the financial sector relative to the market is a commonly used proxy for liquidity conditions. Chart 3 shows a divergence beginning to open up in Japan relative to the US on this measure. Previously in Japan, the strengthening of the JPY since the start of the year, combined with negative rates, have been tightening liquidity conditions considerably. More recently however, the retracement in the JPY suggests some easing in liquidity conditions in Japan.

Chart 3: Liquidity improving in Japan



Source: Bloomberg, 2017

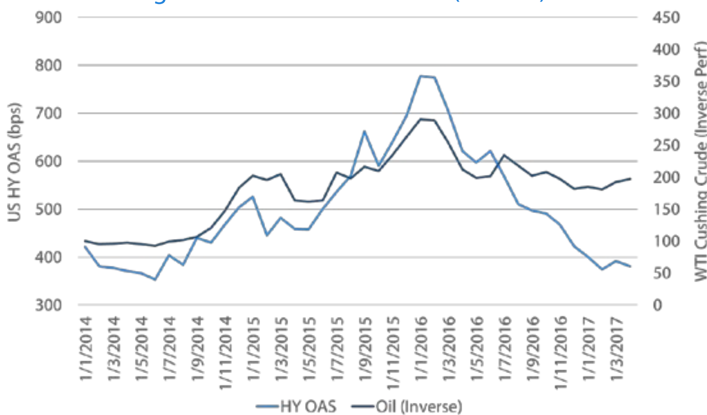
Given the backdrop for strong earnings and still attractive valuations, AxJ equities have been lifted up the hierarchy ahead of the US, where earnings are strong but valuations are increasingly becoming challenged.

Credit

Valuations for Investment Grade improve

After deteriorating last month, valuation metrics for US and Asian Investment Grade (IG) credit have improved, with both markets now showing better valuation support than that of High Yield (HY). US High Yield remained expensive with spreads continuing to tighten, despite weak first quarter growth and a pause in the Trump reflation trade. Perhaps more worrying is the continued disconnect between US HY spreads and the performance of commodities, particularly oil, given that energy is the largest index constituent.

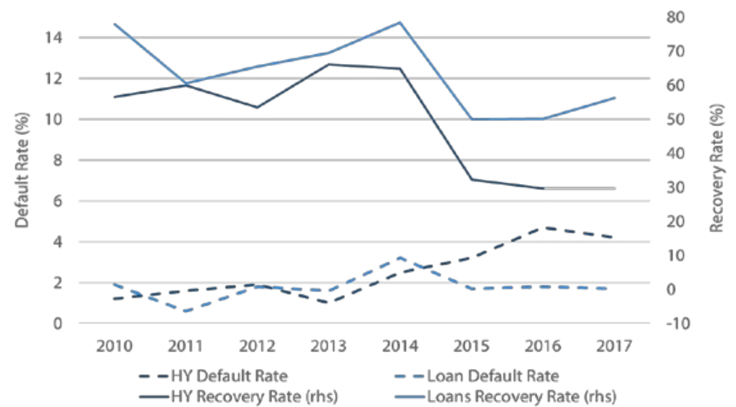
Chart 4: US High Yield OAS vs WTI Crude (Inverse)



Source: BofA Merrill Lynch, Bloomberg, 2017

For the first time since the financial crisis, demand for HY credit has managed to compress yields below that of senior-secured leveraged loans. The Leveraged Loan Index average yield is currently hovering above 6%, whereas US HY has dipped to just below 5.7%. Senior-secured loans rank above unsecured HY debt within a company's capital structure, making this distortion all the more puzzling. Loans tend to have first lien claim on assets and contractual covenants to ensure a higher recovery rate than HY bonds, leading to improved risk-adjusted returns. Loans still exhibit higher recovery rates and lower default rates than their HY counterparts, which can be seen in Chart 5. Loans also benefit from floating rate spreads above LIBOR, which can act as a hedge against rising rates.

Chart 5: Default and recovery rate for US HY and loans (%)



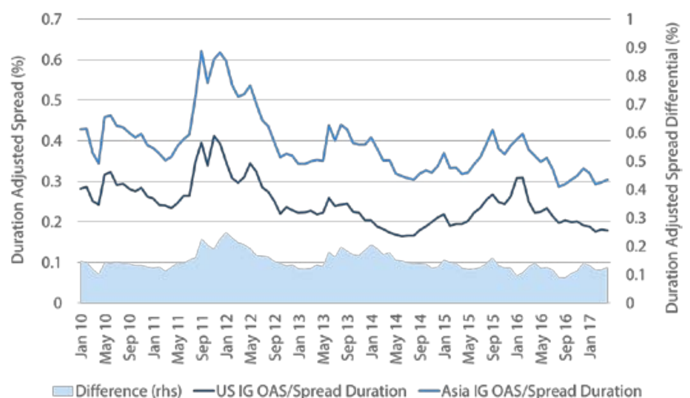
Source: Fitch, 2017

That is not to say that loans are without their risks – the narcotic need for yield has seen flows push spreads down significantly, causing over 25% of the market to refinance over the past few months in order to lock in lower repayments. The covenants that used to make the loan market more secure have been slipping. However, at this juncture, loans may provide better risk-adjusted returns with hedged rate risk at a better price than their HY cousins.

Asian IG option adjusted spreads (OAS) continue to be expensive relative to their own history, as well as versus the US. Both Asia and US IG currently have a yield to maturity of around 3.3% and the difference in OAS is only a measly 20-odd basis points (bps), leading some to question whether this is enough to compensate for 'Asia Risk'. However, this rationale fails to take into account relative shifts in duration.

US corporates have taken advantage of historically low interest rates to refinance further out along the curve, causing average US IG duration to drift higher over the past 7 years. Conversely, Asian IG has seen the average duration fall over this period. The duration on Asian IG is almost 2.5 years less than the US, which means you can earn a similar yield to that of US IG but with 30% less duration risk. When comparing duration adjusted OAS, Asia still looks neutral relative to the US.

Chart 6: OAS vs duration for US and Asian IG



Source: BofA Merrill Lynch, Bloomberg, 2017

In comparing valuations to history, it is important to consider structural reforms that command a lower risk premium that is different than historical averages would suggest. Given the extensive reforms to date and the relative strength of institutions and geopolitics across the region, it is perhaps warranted that the Asia of today should not demand the same risk spread as it has in the past.

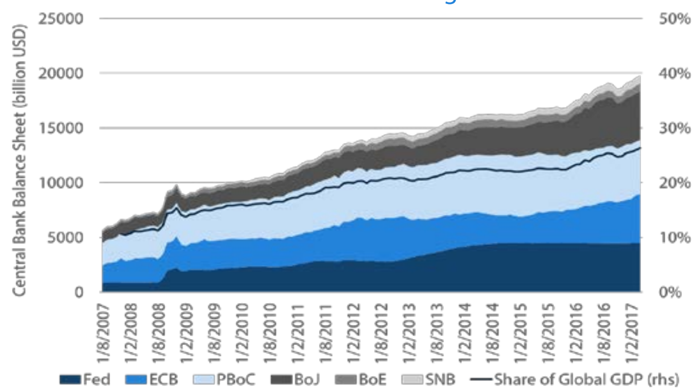
Sovereign

Implications of the Fed reducing its balance sheet

Fears over a Le Pen victory in the French presidential election compressed bond yields, but subsequently reversed on the favourable result. Real yields continued to rise along with the implied probability of a Federal Reserve (Fed) rate hike in June. As the markets are still pricing for just three rate hikes in 2017 (June would be the second hike), the Fed could be frontloading rate hikes so as to pause and allow for balance sheet reduction late in the year. Commentators are quick to proselytise the implications of further Fed rate hikes, a balance sheet reduction and eventual tapering of quantitative easing (QE) by the European Central Bank (ECB) and Bank of Japan (BOJ), but the reality is that no one really knows what the impacts will actually be because there is no precedent.

Since the 2008 financial crisis, the world has only known of Central Banks expanding their balance sheets. As shown in Chart 7, balance sheets have rising from about 15% of global GDP to 40% today. We believe that shrinking balance sheets as well as the road from Central Bank to market pricing is likely to be bumpy.

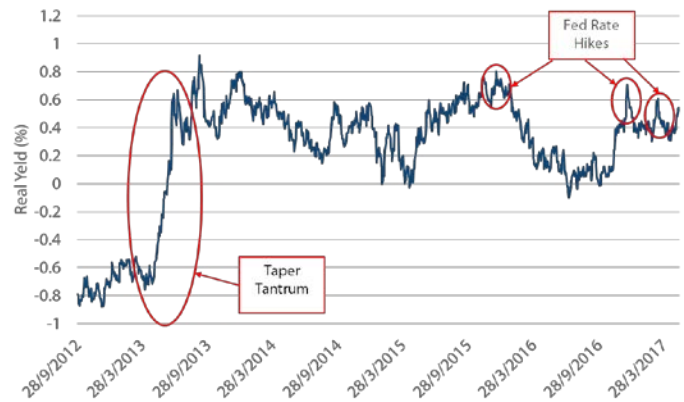
Chart 7: Central Bank balance sheets vs global GDP



Source: Bloomberg, 2017

QE is designed to drive down real yields as it pushes investors into riskier assets in search of higher yield. The aim is to hopefully stimulate real economic growth in the process. As demonstrated by the Fed, BOJ and now ECB, QE slowly loses its potency as real yields compress less and less over time. As shown in Chart 8, US real yields actually began to rise in October 2012 in the midst of QE3, 8 months prior to the Fed announcing its intentions to taper. In fact, the notion of tapering offered the greatest lift to real yields compared to the actual tapering and each subsequent rate hike has since offered progressively lower peaks before compression resumed.

Chart 8: US real yields



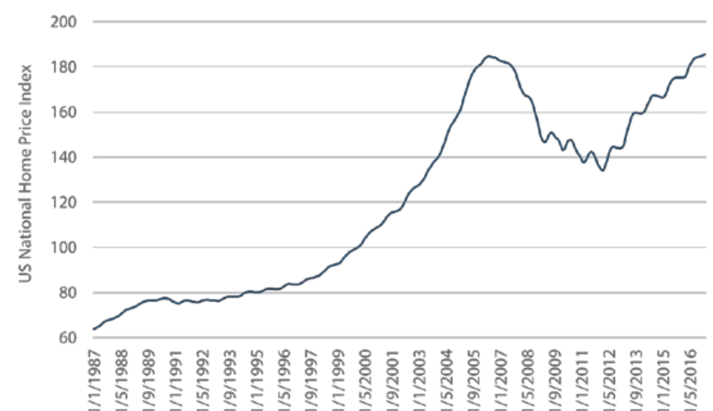
Source: Bloomberg, 2017

The diminishing impact of rate hikes on real yields argues in favour of the Fed's reducing its balance sheet. The Fed will reduce its balance sheet by decreasing reinvestment of bond proceeds, leaving the market to digest up to USD220bn in supply through 2018. This "reverse QE" should, in effect, lift real yields, opposite to that of QE. This is what the Fed is aiming to do, but may limit the pace to start out given the unknown extent or speed of the impact. In any case, rising real yields seems a reasonable bet.

QE never really did make its way into the real economy. The supply of money from the programme instead ended up on bank balance sheets as excess reserves. Since 2008, the Fed has bought USD2.5trn in Treasuries and USD1.8trn in mortgage securities largely off bank balance sheets, the latter of which was intended to artificially lower mortgage rates to lend support to the housing market. The Fed is less keen to hold mortgage securities on its balance sheet, so it is likely that it will let these securities roll off first. The question is whether banks will reduce excess reserves to take mortgage securities back on their balance sheets. Perhaps they will, but only for the right price and, since mortgage rates have been artificially compressed, market pricing means rates will likely need to rise.

As shown in Chart 9, the Shiller National Home Price Index has just crested over its previous peak in mid-2006, so it is rational that the Fed would want to reduce its support for the housing market before it grows into another bubble – if it hasn't already.

Chart 9: Shiller National Home Price Index



Source: Bloomberg, 2017

Re-pricing awaits details of the plan for balance sheet reduction that are soon to be announced. We cannot know the reaction for sure, but based on the above-described dynamics, we do see real yields rising and a potential negative impact on the US housing market as mortgage rates rise. Our longstanding preference is to remain short duration and to limit exposure to those markets offering a reasonable yield cushion against duration risk (US, UK and Australia) relative to markets with little to no cushion (German bunds, Japan JGBs).

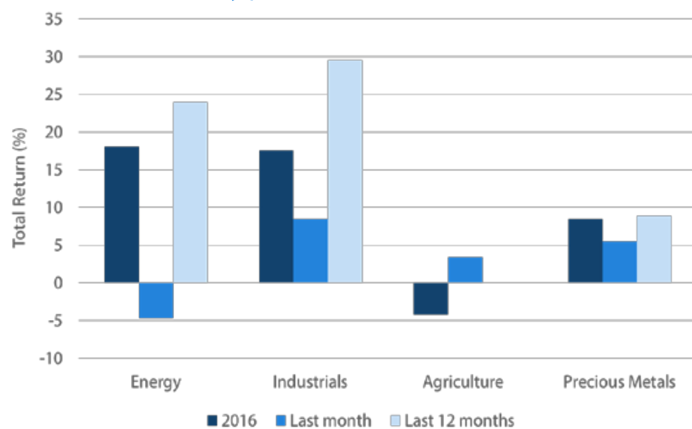
Commodities

Stay overweight on commodities…for now

Reasons for a downgrade to our constructive view on commodities are mounting and include credit tightening in China, rising real yields and prospects for a stronger USD. On the other hand, supply side rationalisation, accelerating global economic growth and generally supportive demand growth for commodities mitigate the downside. For now the balance of risks is perhaps still supportive of a modestly constructive view on the asset class. However we are closely watching the unfolding dynamics of credit tightening in China and politics in the Western world.

We also maintain our relative preference for Precious Metals and Base Metals over Energy and Agriculture. As shown in Chart 10, year-to-date performance is supportive of this view. However this order of preference may also need to be revisited based on how some of the above developments unfold in coming weeks. A sharper than expected tightening in Chinese credit and greater than expected draws in crude inventory would suggest a possible reversal in fortunes of Base metals and Energy, for instance.

Chart 10: Commodity performance



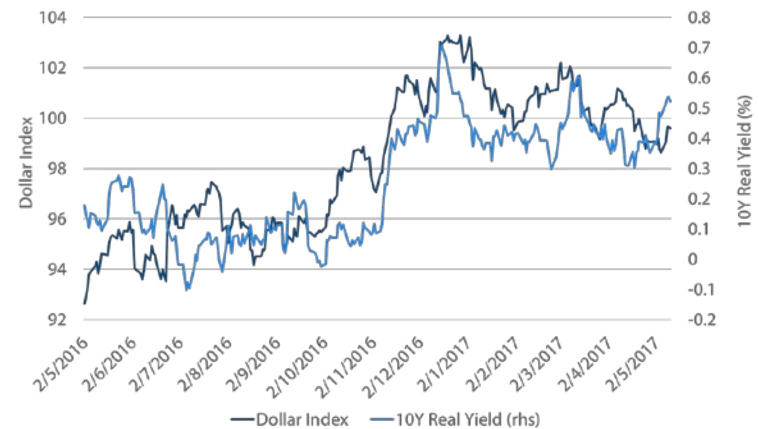
Source: Bloomberg, 2017

Currency

Changing dynamics may add to USD support

Last month, we described the fundamentals that we believe would keep the dollar supported, namely the "dollar shortage" driven by too few dollars flowing into a global economy where the dollar remains the world's reserve currency. We still hold this long-term view though it remains challenged by flows which tend to dominate near-term direction. As described in the sovereign section, while the US continues to hike rates, the impact on real yields is diminishing and, as shown in Chart 11, the lack of real yield support is weighing on the dollar. This means that despite rate hikes, net flows continue to drain out of dollar assets in favour of other opportunities, including emerging markets and European assets.

Chart 11: UST 10 year real yields vs US dollar

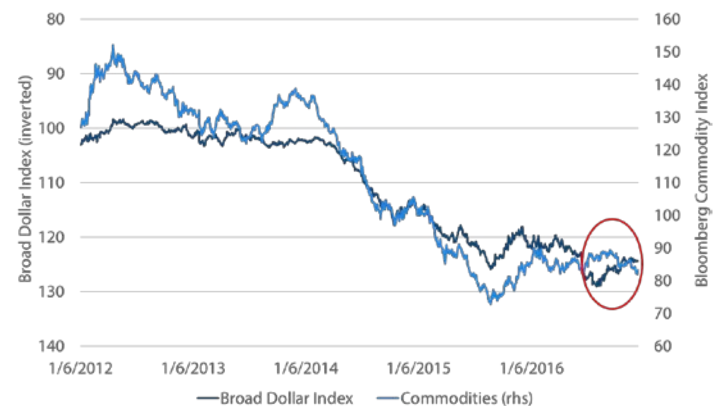


Source: Bloomberg, 2017

However, flow dynamics are likely to change. As the Fed prepares to hike in June, the near-term dynamics favour the dollar as real yields rise, but if recent rate hikes are any guide, this dynamic is likely to be only temporary. On the other hand, reducing the Fed's balance sheet could feature more prominently, leading to a bigger lift in real yields that would lend dollar support. Other sources of support include tight monetary conditions in China and commodity weakness.

As shown in Chart 12, the dollar is inversely related to commodity prices. In mid-2016, this relationship broke down as the dollar and commodities rallied together, but since early 2017, the two have both weakened to meet in the middle and we suspect the inverse relationship will resume. Commodity weakness is still early, but if it persists, commodity exporters that borrowed heavily in dollars could be forced to deleverage.

Chart 12: Dollar (inverted) vs commodities



Source: Bloomberg, 2017

Flows into EMs have remained firm, though with some adjustment among commodity exporters. Should flows slow or reverse, portfolio flows could further add to dollar strength. On balance, while we could see continued dollar weakness after

the June rate hike with real yields remaining compressed, one or more of these dynamics seem likely to lend to dollar support later in the year. We keep the dollar at the top 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 & ROE	Used to inform valuation model	Monetary policy, fiscal policy, consumer, earnings & liquidity cycles
Example		
+	N	N
Final Score +		

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