BALANCING ACT

Nikko AM Multi-Asset's global research views

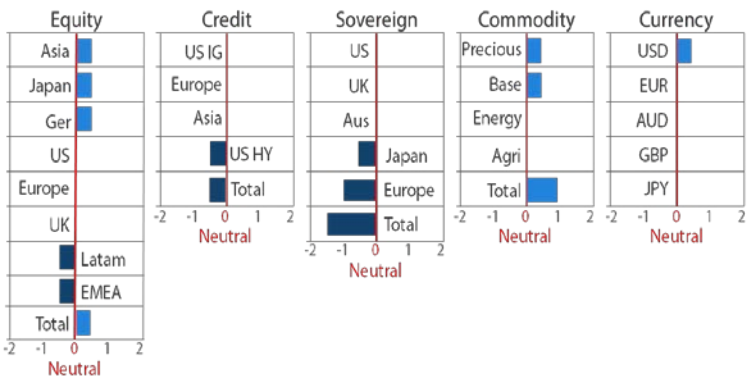
Snapshot

What does it mean to be a value investor? This question is all the more relevant today. The S&P 500, NASDAQ and Dow have all hit record highs as of the time of writing. US equities ranked as one of the most expensive equity markets on our valuation models at the end of last year. Yet they have risen a further 10% since. Gains have been driven by the most expensive part of the market, with the top ten gainers accounting for almost half the rise of the S&P 500 index. Most of these are expensive, growth names. The FANG stocks (Facebook, Amazon, Netflix and Google) soared by a mouth-watering 30% and the S&P 500 Growth index outperformed the S&P 500 Value index by over 10%. Being a value investor has meant a fair bit of pain of late.

The same story repeats itself across other markets and asset classes. The German DAX index with its similarly lofty valuations has enjoyed similarly strong returns this year. The bond market on many measures is even more expensive than equities but it too has posted decent, if not spectacular, gains this year. According to Bank of America Merrill Lynch bond indices, US Treasuries (+2%), UK Gilts (+2.7%) and Australian sovereigns (+3.3%) are all up on the year. It is only Japanese Government Bonds (JGBs) and Bunds that have failed to join the party. It is not surprising that this market environment is pushing many investors to question the merit of valuations in their investment process. Justifying stretched valuations through valuation model alchemy has become another popular fall back.

Our own answer to the above question is that the principles of value investing are just as applicable today as they have ever been. The advice from Benjamin Graham, the father of value investing, to seek a margin of safety in every investment has never rung truer. However, as we have written previously, we believe that the nature of financial market risks has changed from the range of possible outcomes in the middle of the distribution to the loss events encapsulated by the tails of the distribution. This is why volatility is so low, while markets appear increasingly risky. In this environment the margin of safety that value investing offers may not ensure superior performance under a "business as usual" scenario, but it will be more than rewarded over the long term. Indeed, mean reversion is strongest over longer time periods. The more stretched valuations get, the likelier they are to snap back. Hence an anchor in valuations may be the best downside risk protection strategy in this market environment. A valuation anchor may now have become synonymous with prudent risk management.

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.

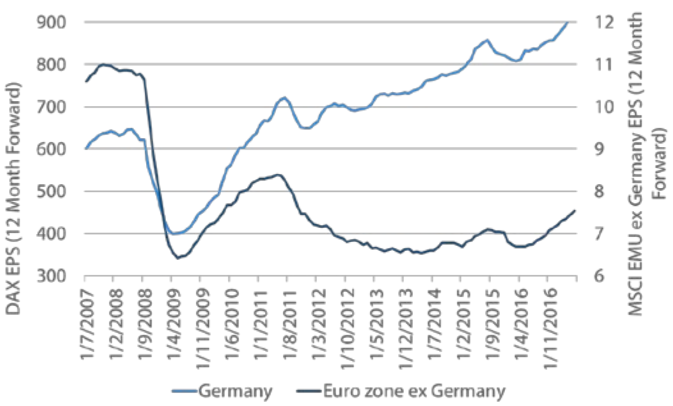
Equities

European equities gain, US slips again

European equities continue to move up our equities hierarchy while US equities slip another notch this month. European equities are in a sweet spot given the combination of three drivers: the reduction in political risk post the Dutch and French presidential elections, inexpensive valuations and strong earnings growth momentum.

As shown in Chart 1, while German corporates continued to deliver strong earnings growth following the global financial crisis (GFC), the rest of the Eurozone struggled to grow earnings. This was a main driver of the divergent performance between Germany and Eurozone ex-Germany. It was also partly why we ranked Germany towards the top of our equities hierarchy, yet remained cautious on the rest of the Eurozone. More recently however, earnings have begun to play catch up outside Germany, which prompted us to upgrade our views on Eurozone equities more broadly.

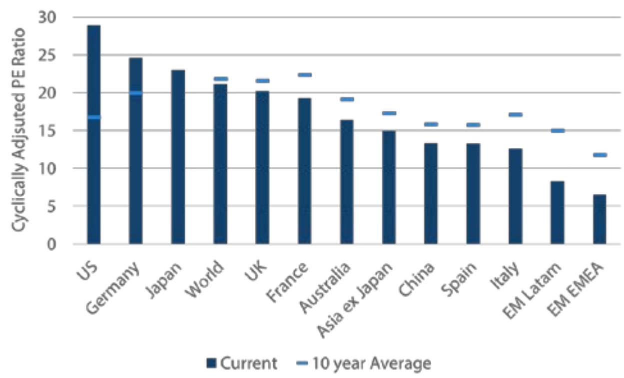
Chart 1: Eurozone earnings momentum



Source: Bloomberg, 2017

Valuations are another tailwind for European equities but a headwind for the US. In Chart 2 we show cyclically adjusted price to earnings (CAPE) ratio for a cross-section of global equity markets. The US at 29x has the highest CAPE in the world. It is also meaningfully higher than its 17x average over the last ten years. Not surprisingly Germany ranks second on this measure. However, the rest of the Eurozone, including France, Spain and Italy, is more attractively valued on both a cross-sectional as well as history-relative basis.

Chart 2: Global equity valuations



Source: Bloomberg, 2017

We recognise that valuations alone are not a sufficient reason to downgrade a market. Valuations are a blunt instrument in the short term as expensive markets can become even more expensive and cheap markets can become cheaper still. This is why we complement our view on valuations with momentum and macro. Momentum doesn't provide much help in discriminating between markets currently. However we see the macro picture improving in Europe and deteriorating in the US. Aside from improved earnings prospects, soaring consumer and small business confidence is another strong tailwind in Europe. On the other hand, we have tempered our expectations around the size and timing of tax reform and infrastructure spending in the US, and downgraded our macro view on the UK given increased political risk. This lifts Germany above the US and the rest of the Eurozone above the UK on our equities hierarchy.

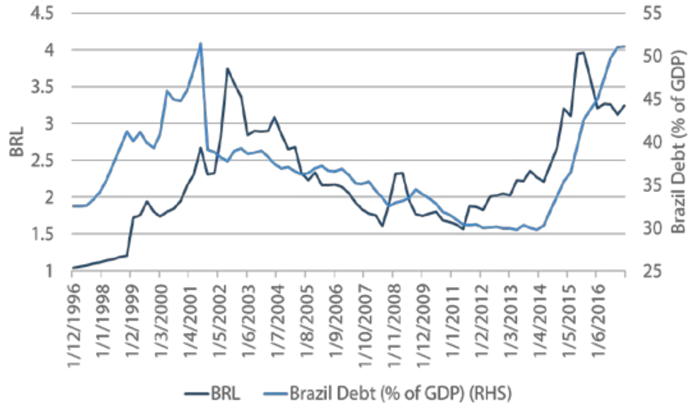
Political risk returns to Brazil

Brazil appeared to be firing on all cylinders over the last year, benefitting from the recovery in commodities starting in 2016 while politics took a turn for the better, with the government promising fiscal reforms to return the budget to a sustainable path. President Temer, who succeeded Dilma Rousseff after her impeachment last year, had managed to stay clear of the growing carwash scandal, until this past month when a released tape implied his payment of "hush money" that is likely to push him out of office. The biggest risk is that it derails the reform process but, so far, markets are giving lawmakers the benefit of the doubt that the reform agenda will remain on track.

There is no question that lawmakers are highly motivated to push forward with reforms, because it is broadly recognised that there is simply no alternative. However, the devil is in the details and Temer had been the chief negotiator in aiming to push pension reform to vote within the next few weeks. As it is, there will clearly be delays and the bill is likely to be further watered down before it is eventually passed. Still, pension reform does more to control future spending than it does current, so the delay has less of a near-term impact on the fiscal account. Based on reforms passed to date including spending caps, the budget deficit is expected to slowly decline with debt levels peaking in 2022.

Projecting peak debt levels in five years' time provides hope, but it also leaves little room for error given the already high levels of debt. As shown in Chart 3, levels are already near the 2000 peak, while the currency is similarly weak. The Brazilian Real weakened moderately following the latest news implicating Temer, but this is barely noticeable in the context of the broad gains since late 2015. Inflation has dropped precipitously, reaching 4.1%, which allows for continued rate cuts, but likely at a slower pace as the central bank is cautious with respect to the likely slowdown in reforms.

Chart 3: Brazilian Real (BRL) versus Debt-to-GDP as % of GDP



Source: Bloomberg, 2016

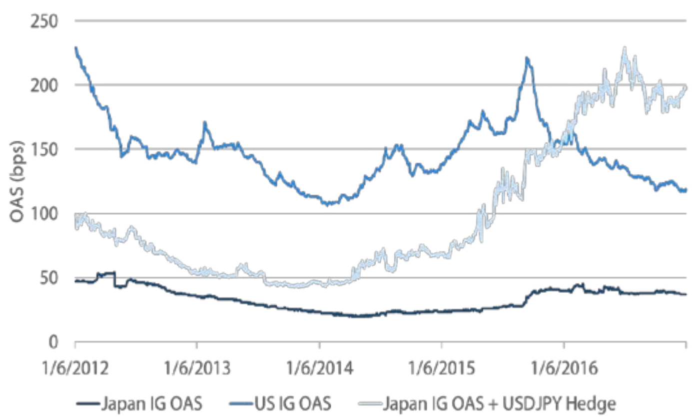
On balance, despite positive momentum and improving macro, our caution regarding valuations and the risk of earnings not delivering keeps Latin America (Latam) on the lower end of the equity hierarchy. For some time, we have been cautious on valuations given the implied V-shape recovery already baked into earnings estimates, where the growth recovery is likely to be more protracted given high levels of debt and still-rising unemployment. Recent commodity weakness also presents potential downside risk as China continues to keep policy tight.

Credit

Japan investment grade (IG) shows value

Japan IG remains one of the only credit markets with positive valuations. Despite the fact that the option-adjusted spread (OAS) is only a mere 40 or so basis points (bps), far below what US or Asian IG has to offer, it remains cheap relative to its own history, which averaged around 30bps over the past 20 years. Japan IG also looks cheap relative to US IG over history, with a relative OAS spread of around -75bps, compared to a 20 year average of around -120bps. However, despite cheap valuations, is owning an asset with such low absolute yield worth it? With the potential for spread compression and an extra 1.5% pick up when hedging JPY to USD, we believe the asset class may be more attractive than the absolute yields would suggest.

Chart 4: Investment Grade OAS



Source: Bloomberg, 2017

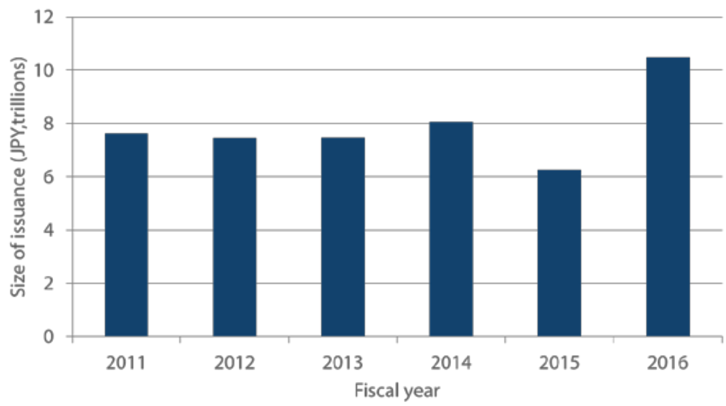
2013 saw Japan IG spreads tighten as the Bank of Japan (BoJ) decided to make the bold move of engaging in quantitative easing (QE). However, after a rough start to 2016, when crude oil and equity markets plunged on the back of China's deceleration and rising US interest rates, spreads expanded back to pre-QE levels. In response to such a deteriorating macro environment, BoJ introduced negative interest rates, which was intended to support the economy and weaken the Yen, but ultimately ended up confusing investors, causing more risk aversion. As a result, Japan IG spreads expanded further.

Chart 5: 5-year Japanese corporate bond spread

Source: Bloomberg, 2017

Spread widening can also be attributed to the large supply of issuances. Since 2011, the average range of Japanese corporate issuances has been between 6 to 8 trillion yen per annum (p.a.) (approximately USD 54bn to 72bn), but in 2016 it exceeded 10 trillion yen (USD 90bn). This increase was attributed to banks selling issues to raise new capital requirements and corporates rushing into capital markets to take advantage of negative interest rates. This activity appears to have slowed in 2017, after the BoJ introduced curve control last September.

Chart 6: Japanese corporate bond issuance



Source: Bloomberg, 2017

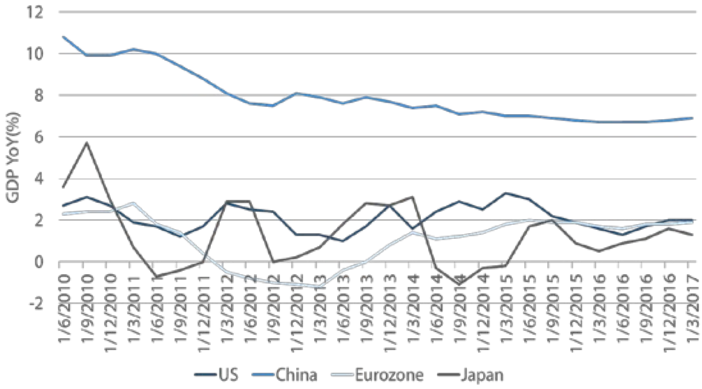
We believe spreads could tighten in 2017 as issuances decrease and local demand continues to buy up positive yield, along with the continuation of BoJ's asset purchasing programme. The outlook for Japanese corporates continues to look bright, with positive macro tailwinds and improving liquidity conditions. However the main concern remains the ultra-low interest rates from BoJ manipulation. Any adjustment to the current JGB zero rate policy could see sovereign bonds sell off, causing Japan IG to suffer. Despite escaping deflation, the country is still a long way from meeting its inflation goal of 2%. Kuroda has since pledged to continue to control the yield curve until this is met.

Sovereign

Bond value in the eyes of the beholder

With the US 10-year Treasury yield setting a new low since November, assessing fair value in global sovereign bonds has once again become a hot topic of conversation for investors. A more traditional assessment of the landscape for bonds would suggest that valuations are quite rich and that 10-year nominal yields well below long term averages are decidedly unattractive. This is particularly so in an environment where we are seeing a sustained period of synchronised growth across the world's four largest economies.

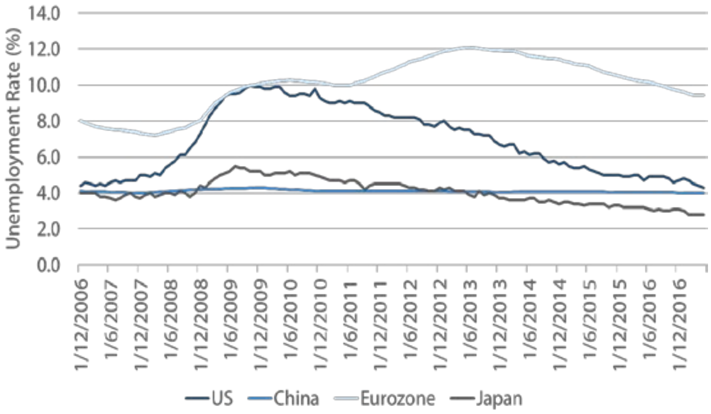
Chart 7: GDP growth



Source: Bloomberg, 2017

This stable economic growth is also reflected in robust job creation as unemployment rates trend lower.

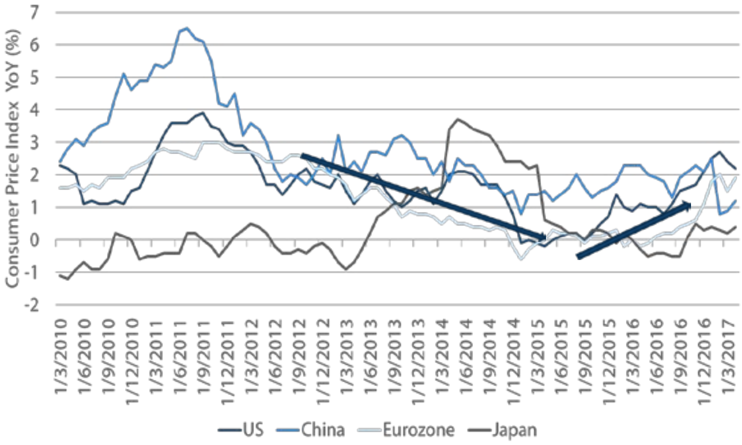
Chart 8: Unemployment rate



Source: Bloomberg, 2017

In the post GFC period, consumer price inflation drifted lower and moved into deflation in all of the economies shown in Chart 9, with the exception of China. However, inflation rates have been trending higher over the past 18 months and both the US and the Eurozone are recording their strongest inflation since 2012-13. Inflation in Japan was of course hurt by an increase in the consumption tax in 2014, but even here we are seeing positive price changes.

Chart 9: Consumer Price Index



Source: Bloomberg, 2017

When we add in the fact that the Federal Reserve (Fed) has begun to raise its official cash target and other central banks are no longer increasing their efforts to ease monetary conditions, this is not generally an environment that we would associate with sovereign bond yields trending lower.

So against this economic backdrop we ask ourselves: why would investors want to continue buying bonds and lock in such low returns?

The first reason has been playing out over our Twitter feeds, news feeds and televisions over the last six months. Political risks have been amplified with an unpredictable US president in the White House, elections in Europe and ongoing terrorism threats. As fear and uncertainty rise, sovereign bonds remain in demand as a safe harbour for investors' dollars.

The second reason is that, although central bank policy changes have been quieter of late, the large QE programmes and negative interest rates are still very much in place in Europe and Japan. These programmes have generally created incentives for Japanese and European investors to seek out positive returns. Suffice to say that this "carry trade" is alive and well for many JPY and EUR investors. When we look at currency hedged yields available to these investors, the problem becomes apparent. We show an example for JPY-based investors in the table below.

JPY	FX Hedged				
Term	US	UK	GE	AU	JN
3-mth	-0.66	-0.18	-0.47	-0.58	-0.12
6-mth	-0.55	-0.22	-0.41	-0.59	-0.12
1-yr	-0.48	-0.37	-0.44	-0.58	-0.14
2-yr	-0.33	-0.40	-0.41	-0.53	-0.14
3-yr	-0.20	-0.33	-0.38	-0.45	-0.13
4-yr	-0.03	-0.27	-0.27	-0.32	-0.12
5-yr	0.09	-0.04	-0.14	-0.20	-0.11
7-yr	0.34	0.19	0.11	0.03	-0.08
8-yr	0.42	0.30	0.26	0.12	-0.04
9-yr	0.49	0.45	0.40	0.19	0.00
10-yr	0.53	0.50	0.58	0.24	0.04

Yields available on JGBs are shown in the last column, where the impact of BoJ's negative interest rate and yield curve control policies can be seen clearly. As Japanese investors venture offshore they are confronted by currency hedged yields that are also negative out to 4-5 years. In order to earn a positive return from strong sovereign bonds without taking FX risk, investors need to focus on longer maturity bonds, creating demand for seemingly low yielding bonds. Comparable analysis for EUR-based investors would show a very similar dilemma.

So we have a global economy that is doing quite well by the commonly used measures of GDP growth, low unemployment and low and stable inflation. While this is not normally an environment where bond yields trend lower, we also have an uncertain world and a strong incentive for many investors to seek out positive yields where few options exist at home.

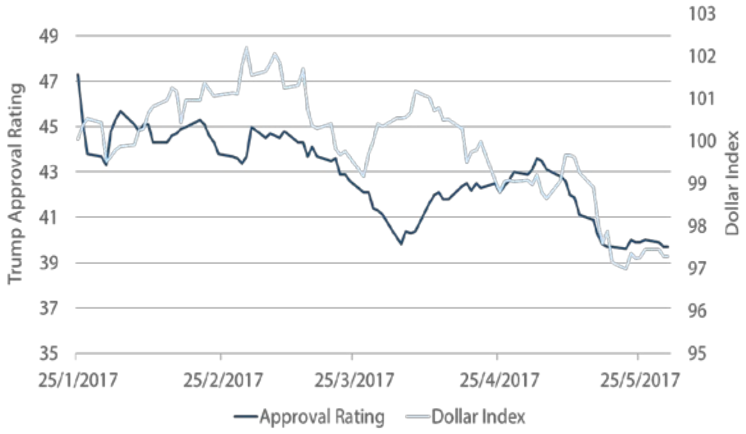
While we don't see any particular near term catalyst that is likely to spook bond investors, we think that the steady improvement in the global economy can continue and will eventually lead to other central banks joining the Fed to slowly withdraw from the bond-friendly policies of the last 10 years. Only then will bond valuations be revealed for what they are, expensive.

Commodities

Precious metals back on top

Precious and base metals have done well this year. They have both been beneficiaries of the weaker dollar given the negative correlation between commodity prices and the dollar. While a stronger dollar could conceivably hurt them both, we think there is a plausible scenario where the dollar remains weak but base metals sell off. A further clampdown in China on credit growth and speculation and continued political drama in the US could depress base metals due to the China effect while keeping Gold supported through a safe haven bid. Chart 10 shows the tight correlation between Trump's approval rating and the USD this year.

Chart 10: Trump approval rating and the USD



Source: Bloomberg, 2017

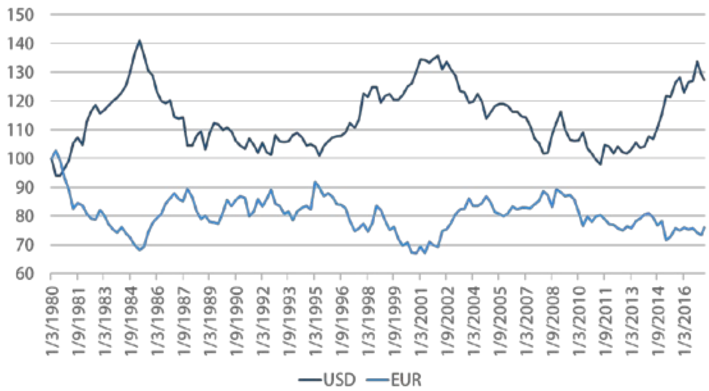
The updated commodities hierarchy now has precious and base metals above energy and agriculture.

Currency

Growth momentum and politics currently support the Euro

Valuation also drives currencies, but in the case of developed markets, cycles tend to be much longer making mean-reversion much more difficult to predict. The real effective exchange rate shows the dollar as very expensive in Chart 11. Currently it is around the same peak levels reached in 1984, just before the Plaza Accord coordinating central banks to weaken the greenback, and in 2000 just before the dotcom crash. The Euro is largely the mirror image of the dollar, making the currency more attractive from a valuation perspective.

Chart 11: Dollar and Euro real effective exchange rates compared

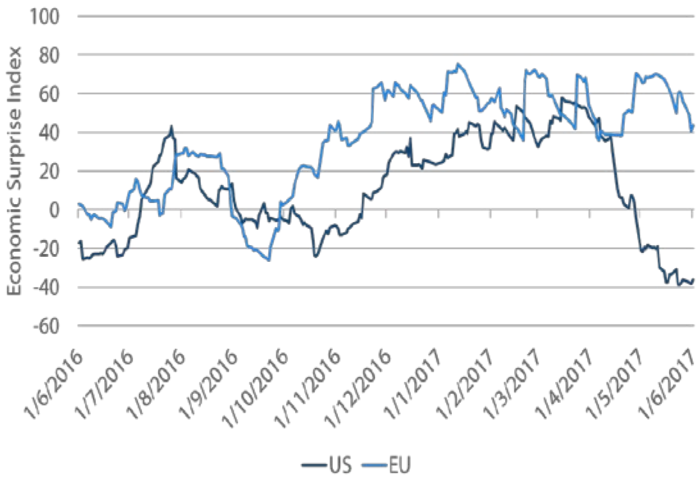


Source: Bloomberg, 2017

We usually think of currencies as policy driven, rising and falling with the rate cycle, but over the long term they are driven by relative growth and both prior peaks in the dollar are associated with periods of promising growth. By 1984, the Fed had finally slain the inflation dragon; this, coupled with Reaganomics, initiated the strongest growth cycle since the 1960s. The 1990s introduced a similar boom, this time driven by technology. After the 2008 financial crisis, the US was the first to respond with aggressive policies leading to a speedy recovery compared to the rest of the world, and peaking with Trump-related optimism for tax and regulatory reforms coupled with the promise of fresh stimulus. Fading Trump hopes coupled with resurgent growth elsewhere has naturally shifted momentum away from the dollar since early 2017.

US hope for reforms and stimulus continue to be discounted by Trump's repeated blunders, but the more important driver of diminished growth prospects is the degree of disappointment in recent US economic data. Chart 12 compares the economic surprise indices from the US versus Europe. While the index for Europe has remained relatively positive since late 2016, growth surprises out of the US have fallen sharply since mid-March, coinciding with the Fed's last rate hike. While the Fed states that it is "data driven" in determining its path to policy normalisation, disappointment is so far not hindering the high likelihood of a rate hike in June, which seems to be the source of the flattening yield curve.

Chart 12: Citi economic growth surprise index



Source: Bloomberg, 2017

Importantly, while the political risk premium in the US is rising, Macron winning the French Presidential election offered significant relief, helping to add to Euro momentum. The US and Europe are far from trading places in terms of the relative strength of their institutions, but change at the margin causes shifts in momentum. Still, political risk in Europe has not fully abated. Italian elections, which could be called as early as September 2017, pose the biggest risk.

Policy divergence remains a key driver of relative currency performance, and tighter policy in the US has been a major source of dollar strength as the rest of the world has kept policy easy. However, in April, the European Central Bank (ECB) reduced its asset purchases from EUR80bn to EUR60bn per month with further reductions expected later in 2017 or early 2018. Yes, policy remains easy, but it is policy change that tends to drive momentum, and a more hawkish ECB would clearly be supportive of the Euro.

We still believe there are structural pillars of dollar support, including the dollar shortage of USD10tn of dollar denominated debt outside the US and less supply for a still meagre current account deficit. Dollar liquidity will be further tightened when the Fed begins to reduce its balance sheet, which is dollar supportive. Dollar strength tends to be self-reinforcing as strength causes greater demand for dollars to deleverage dollar denominated debt. For the moment, the dollar remains relatively week so this dynamic has yet to come into play.

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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