BALANCING ACT

Nikko AM Multi-Asset's global research views

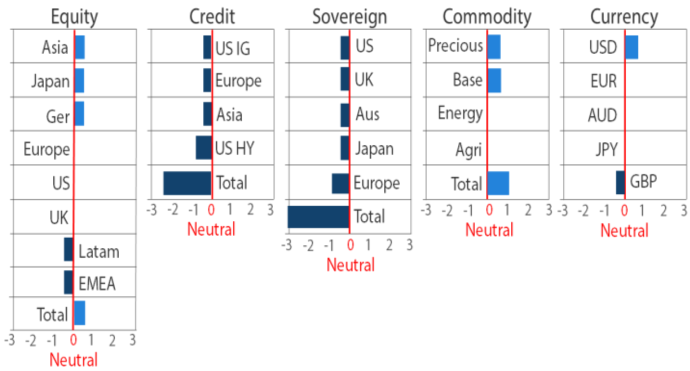
Snapshot

Could this be taper tantrum 2.0? Markets are well-conditioned to buy risk on the back of generally dovish encouragement by central bankers, but what are we to make of this new seemingly coordinated hawkish tone across the developed world? Inflation is an unlikely culprit given the downside surprise, but at least the Federal Reserve (Fed) believes it is coming soon due to very low levels of unemployment. We will have to wait and see, but some central bankers have voiced concerns about markets appearing expensive or even frothy – from property in Europe to equity markets in the US. We find this argument more credible, but central banks aim to target inflation and not asset prices, at least as far as they say. In any case, it appears that easy policy is set to be withdrawn, which probably means higher volatility as markets reprice almost forgotten risk.

Real yields are on the rise and weighing on risk assets, with pockets of momentum giving way to some degree of mean reversion. Expensive Technology stocks have sold off, while attractively priced Financials have been driven up on more promising revenue prospects due to steeper yield curves. The moves are orderly and arguably healthy, but we are mindful of the potential fat tail given the severe mispricing of volatility. Big money strategies such as Risk Parity or Risk Targeting are inherently short volatility, often on a leveraged basis. Higher volatility means potential forced selling (or buying of volatility) that, at some point, can lead to market extremes.

Still, we do not think that we are there yet. Central banks tend to get what they want, and what they would not want is to undo the wealth effect that they have carefully nurtured for nearly 10 years. So far, we have heard only rhetoric with no hard plans to remove stimulus outside of the Fed taking baby steps on rate hikes and allowing a small reduction of its balance sheet. The markets reacted more strongly to European Central Bank President Draghi's statement that "deflationary forces had been replaced by reflationary ones". This would ordinarily be a good thing, but in this context it implies the removal of quantitative easing (QE) stimulus. However we suspect that Draghi will be able to placate markets with whatever plan he presents. Back in April, he had already reduced QE once by 10 billion, but markets did not take notice as they had been convinced that it was not tightening. Hence we are more concerned about the impact of overall stimulus removal as it gathers pace in 2018 – both through the shrinking of the Fed balance sheet and some form of tapering by the ECB. In the meantime, reflation offers support to earnings, while sticking to value principals is ultimately the best protection against downside as conditions eventually grow tighter.

Asset Class Hierarchy (Team view[1])



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

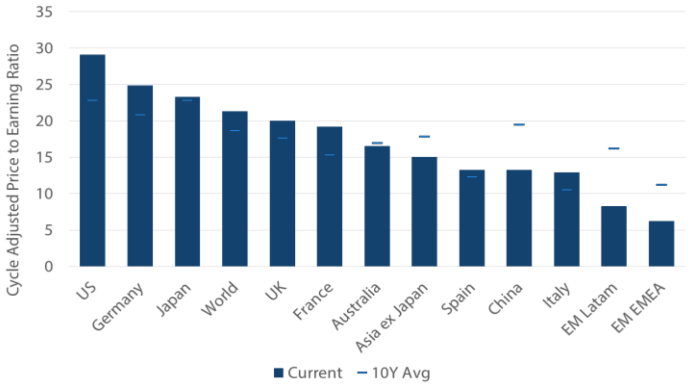
[1]The asset classes or sectors mentioned herein are a reflection of the portfolio manager's current view of the investment strategies taken on behalf of the portfolio managed. These comments should not be constituted as an investment research or recommendation advice. Any prediction, projection or forecast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

Equities

Upgrade European equities over the US

We lift European equities above the US on our equities hierarchy this month given a continued ebbing of political risk, inexpensive valuations and strong earnings growth momentum. European equity performance appears to have stalled in recent weeks on concerns around the direction of monetary policy and rising bond yields, which we will discuss in more detail later in this report. However the strength in the Euro does mean continued outperformance in common currency terms. The spike in bond yields serves as a timely reminder on the attractiveness of valuation support as a way to mitigate downside risk. Hence we believe unhedged European equities offer better risk adjusted upside from current levels than the more expensive US market.

Chart 1: Global equity valuations



Source: Bloomberg, 2017

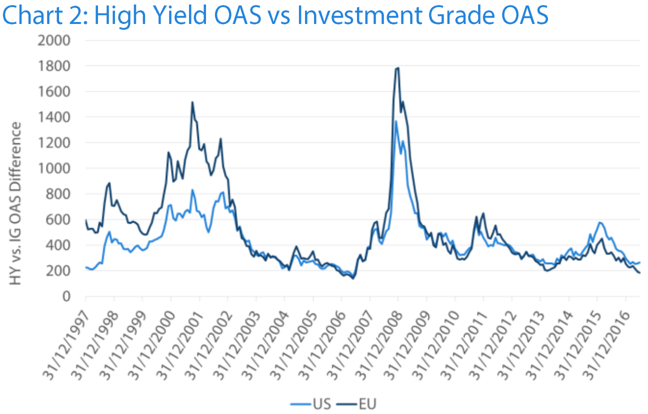
Chart 1 above shows relative valuations of global equity markets relative to their long term average. This chart is similar to the one we included last month but we have corrected it for an inadvertent omission on the long term average for Japan previously.

Credit

High Yield Remains Expensive

Not all high yield markets are equal. Some countries are experiencing improved fundamentals and outlook, while others are starting to show signs of deterioration. However, what they all have in common is excessive valuations, with spreads relative to investment grade near cycle tights.

Chart 2: High Yield OAS vs Investment Grade OAS

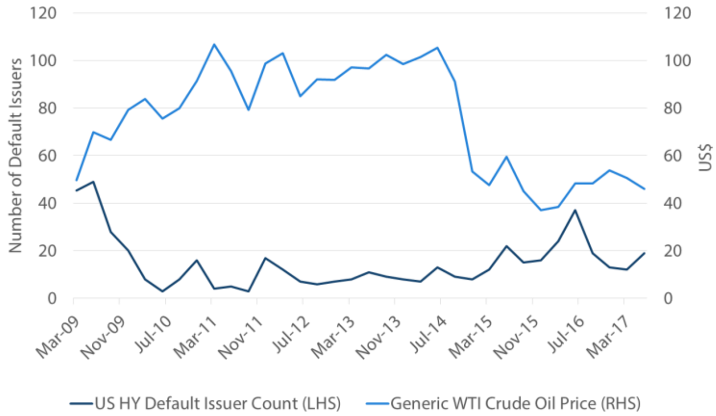


Source: Bloomberg, 2017

The overall mood in the US has been optimistic – sweeping tax reform, pickup in growth and commodity price revival saw spreads in US high yield tighten throughout the year. Spreads have remained tight, despite these views failing to live up to expectations. Based on the current relative spreads to investment grade, US high yield is priced for a stable mid-cycle environment, however, underlying credit signals remain moderately weaker than historical mid-cycle periods.

Spreads are tightening during a time when corporate leverage remains high and continues to grow, while central bank liquidity is expected to roll off. This increase in leverage has caused interest coverage to weaken to the lowest level post-crisis, despite yields being 40% lower than they were back in 2007. Excluding Financials, leverage is now higher than the pre-recession peak, with Materials and Energy leverage expanding significantly. With oil starting a new downtrend and default issue count starting to rise yet again, we would argue the current relative spread to investment grade is unwarranted.

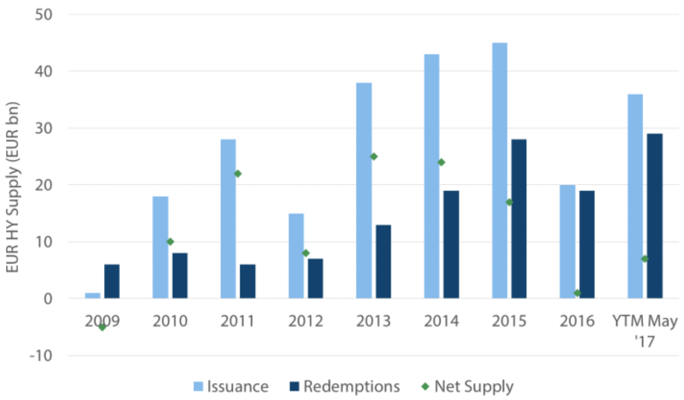
Chart 3: US High Yield Defaults by Issuer Count vs. WTI Oil Price



Source: Fitch Ratings, Bloomberg, 2017

Conversely, the growth outlook in Europe is probably the best we have seen in years. Unlike some disappointment seen elsewhere, Europe is experiencing positive economic surprises, its financial conditions are supporting growth and dispersion across economies is narrowing. Default rates saw a rise in 2016, but these are expected to come down to below 1% in 2017 as the growth outlook and earnings potential improves across the region. In contrast to the US, easy credit conditions and low rates have not led to indiscriminate issuance, with net supply underwhelming, as shown in Chart 4. There has been very little re-leveraging, with most new supply being used for refinancing. Spreads on EUR high yield are similar to the prior cycle, but the composition of the index has become markedly higher quality, tilted more towards BB issues with few CCCs. However, the current price already reflects these improvements, with spreads relative to investment grade at the second lowest point in the past 20 years, only slightly eclipsed by the pre 2008 tight. While European investment grade is at risk for spread widening when the ECB start to taper, non-corporate sector purchase programme (CSPP) eligible issues offer an attractive pick up which should be more sheltered from any change in policy. We prefer to be selective within investment grade at present.

Chart 4: EUR High Yield Supply (EUR bn)



Source: J.P. Morgan, 2017

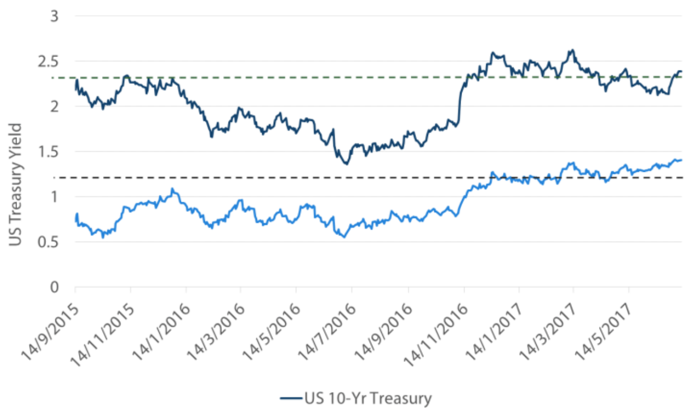
We continue to favour investment grade across the board, but acknowledge the embedded sovereign risk during this hawkish period.

Sovereign

Central Bank hubris?

Starting with the US Fed's Federal Open Market Committee (FOMC) June meeting followed by the ECB's Forum on Central Banking, central bankers have continued to make their presence felt in financial markets. The FOMC's decision to tighten monetary policy again for the third quarter in a row is certainly a vote of confidence in the strength of the current US economic expansion. It would appear that the FOMC's ultra accommodative policies since the global financial crisis (GFC) have successfully supported the US economy and the Fed has now begun the process of slowly restoring "normalcy" to monetary policy. And as the saying goes, so far so good. Since the resumption of monetary tightening in December 2016, US 2-year note yields have risen in line with the official cash rate and 10-year note yields have been relatively stable. Even FOMC discussions on reducing, and eventually ending, reinvestments of cash flows from the Fed's portfolio holdings could not disturb this orderly transition.

Chart 5: US Treasury Yields



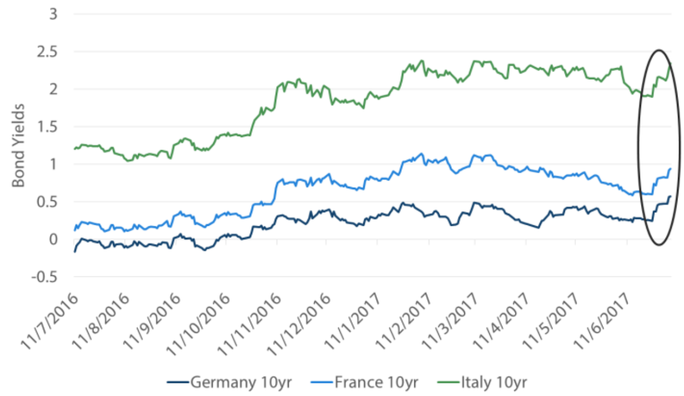
Source: Bloomberg, 2017

The ECB is also equally impressed with their work in the post GFC period. ECB President Mario Draghi recently opened the Forum on Central Banking, telling attendees that monetary policy has been very effective in raising economic demand in the Eurozone. Their goal of creating general reflation is taking longer but is also on track, according to the ECB themselves. The combination of three policy instruments; low to negative official cash rates, asset purchases and forward guidance, have seemingly worked handsomely.

Not that we want to rain on these Central Bank parades, but we believe the jury is still out on the "success" of these policies. Like a sport's team that celebrates a little too much over a healthy lead at half time, there is still a lot of game to be played before the results are in. Our primary concern is how bond markets will react to the reverse in direction from the three policy tools. On the way into this policy mix, bond yields trended lower and volatility followed to very low levels. This stability in itself was supportive of markets and economies.

The question for us now is whether markets can remain stable as central banks change course. The evidence so far is mixed, with the Fed making a good start but with greater concerns existing in Europe's bond markets. Draghi's recent remarks were interpreted by the market as hawkish and possibly a precursor to ECB action on changing its policy mix to be less accommodative. This perceived change in the ECB's tone kicked off a rapid push higher in bond yields across the Eurozone.

Chart 6: European Government Bond Yields



Source: Bloomberg, 2017

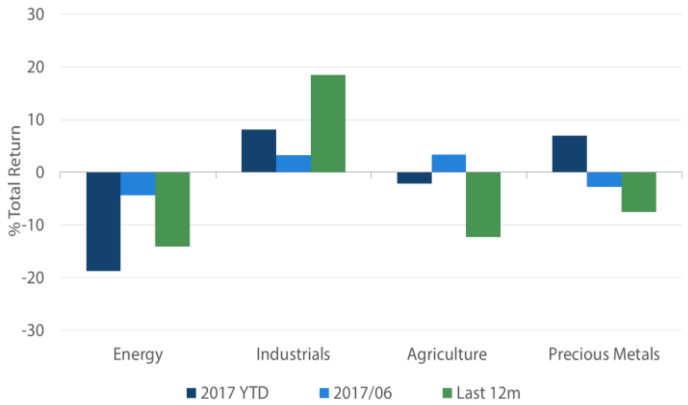
Although this recent sell-off in developed bond yields may prove to be premature, we think the reaction function to less accommodative monetary policy should not be ignored. As a result we remain cautious on developed bond markets and continue to maintain lower durations and higher cash holdings than is typical of our developed sovereign bond allocations.

Commodities

No changes to our commodities hierarchy

We make no changes to our commodities hierarchy although higher bond yields do call into question our preference for precious metals over base metals. As shown in Chart 7, both precious and base metals have been beneficiaries of the weaker dollar this year. This is to be expected given the negative correlation between commodity prices and the dollar. We can certainly foresee a scenario where a stronger dollar could conceivably hurt them both, but we believe base metals could be exposed to the greater downside if the USD strength came along with slowing credit growth in China and higher political uncertainty. So far we have not seen such a scenario play out. The Dollar has remained weak. However bond yields have risen strongly and weighed on gold. If this continues, we may need to consider a change in the hierarchy. However for now we remain comfortable with a preference for precious metals over base metals, and rank Energy and Agriculture at the bottom

Chart 7: Commodities Relative Performance



Source: Bloomberg, 2017

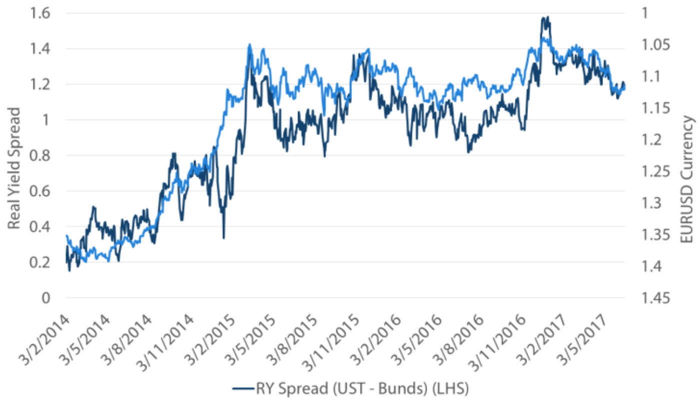
Currency

Euro lifted to join Dollar at the top of the hierarchy

The coordinated shift by central bankers to a more hawkish tone has lifted real yields across developed markets, but to varying degrees, lending the most support to the Euro. As we have long noted, the Euro remains cheap but kept so by ECB's efforts to compress real yields through QE. Ultimately, QE is designed to fight deflation, so when Draghi stated that "deflationary forces had been replaced by reflationary ones", it was no surprise that real yields lifted and the Euro strengthened.

Draghi's comment was really a statement of the obvious given the positive economic surprise that has finally spread beyond Germany to now include the periphery. Moreover, the populist momentum stemming from BREXIT and Trump's victory seems to have diminished with events such as the recent Presidential election of Macron in France, allowing pro-Eurozone leadership to maintain and even strengthen their power. Returning growth and political stability is reflationary, and markets have been steadily dragging real yields higher since the beginning of the year in spite of continued QE. Conversely, the unwind of the Trump reflation trade has caused US real yields to compress, lending natural support to the Euro as shown in Chart 8.

Chart 8: Real Yield Spread of 10Y USTs over 10Y Bunds versus EURUSD (inverted)



Source: Bloomberg, 2017

We lift the Euro to the top of the hierarchy alongside the dollar, based on a presumed shift in policy. We do not expect a taper tantrum like that experienced in 2013, as the ECB has a strong interest in keeping the Euro weak so as not to depress further already low levels of inflation. However, the ECB has yet to articulate any specifics concerning the shift. Hence we see an even chance for the Dollar to return to strength based on actual tightening, including further rate hikes and a soon to be shrunk Fed balance sheet which should naturally lift real yields while removing dollar liquidity. This could potentially exacerbate the "dollar shortage" where more than USD 10trn in foreign dollar denominated debt becomes difficult to finance.

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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