BALANCING ACT

Nikko AM Multi-Asset's global research views

Snapshot

Over the past few years, one of the main risks that concerned our team was the possibility that asset classes could become positively correlated. In 2017, we saw the positive correlation story start to play out in the best possible way, with strong positive returns across the board. Equity markets continued to benefit from the resurgence of global trade and subsequent earnings recovery. Corporate bonds saw spreads narrow further as companies improved their profitability and default rates diminished. Despite stubbornly expensive valuations and the increasing probability of rate hikes and tapering, even sovereign bonds delivered over the year. Oil added, gold added and obscure crypto currencies became household names. Unless you were excessively long the US Dollar, Agriculture or MLPs, chances are you had a pretty good year.

2016 felt quite a bit different. Geopolitical upsets such as the Chinese Yuan devaluation, BREXIT and the US Elections set the stage for uncertainty and volatility. Rather than seeing this uncertainty percolate into the following year, 2017 saw historically low volatility decline even further. The US Volatility Index (VIX) continued to decline over the year, dropping below the glory days of 2005 and 2006 to the lowest point on record. Despite some geopolitical flashpoints – failed US Healthcare Bill, potential Russian collusion, election upsets in the UK and Germany, rising tensions with nuclear armed North Korea, to name a few– investors looked through the news in 2017 to the underlying growth drivers, effectively plugging the dyke of any extended selloff.

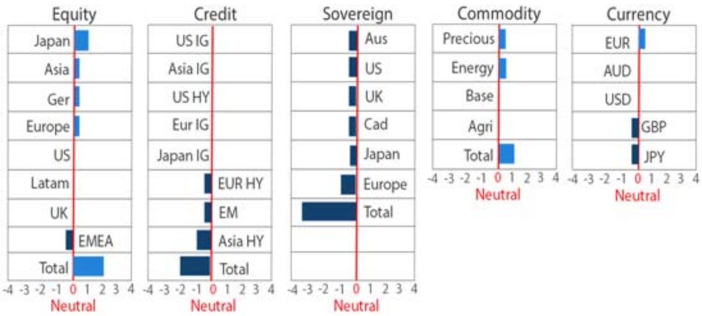
However, we have discussed before the perils of viewing risk only through the volatility lens. Excessively accommodative monetary policies over the last ten years have dragged both bond yields and volatility lower. 2018 may be the turning point as monetary policy gradually shifts tighter. The US Federal Reserve (Fed) will continue raising rates and reducing its balance sheet, while the European Central Bank (ECB) will cut their quantitative easing in half this year. Even the Bank of Japan (BOJ) is starting to sound relatively more hawkish as Japanese banks continue to suffer from weak profitability. The turning point for policy will shift liquidity, which should start to tighten financial conditions this year. This will likely place pressure on those markets most vulnerable, which could have the potential to increase idiosyncratic volatility this year.

That said, fundamentals continue to be strong across most markets. Global growth and trade continues to improve, leading to stronger earnings globally. The US consumer remains strong, joined by stronger consumption from Asia and Europe, which is likely to continue to support global demand. Emerging markets (EMs), which are historically more vulnerable to tightening financial conditions, have undergone meaningful reforms to be more resilient than they were 10 years ago. Most of EM is well positioned to survive weaker demand for exports, though slowing demand seems unlikely given that Europe is still early in its recovery. High EM savings rates, more so in Asia, provide a buffer against liquidity withdrawal. Therefore the outlook is still bright. However, this doesn't mean that some external event may not rock the boat.

While investors managed to look through the geopolitical flash points last year, their resilience may fatigue if issues escalate or more "unknown unknowns" come to light. With the US taking a backseat in global stability, any regional flare up may be more destabilising than in the past. At the time of writing, at least 20 people are considered dead as anti-government protesters take to the streets in Iran. Just as domestic protests in Syria escalated to send shockwaves across the world, from the migrant crisis dividing EU member states to Russia flexing their muscles on the global stage, these unforeseen events can trigger new and unfolding paths which investors must navigate with caution.

While we are still bullish on the global growth story, volatility is likely to return this year. We do not believe that volatility is necessarily a bad thing, in fact it is healthy. This environment should help separate winners from losers, rather than expecting the tide to lift all boats for another year. While we remain positive, this divergence should make asset allocation decisions all the more important in 2018.

Asset Class Hierarchy (Team view[1])



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

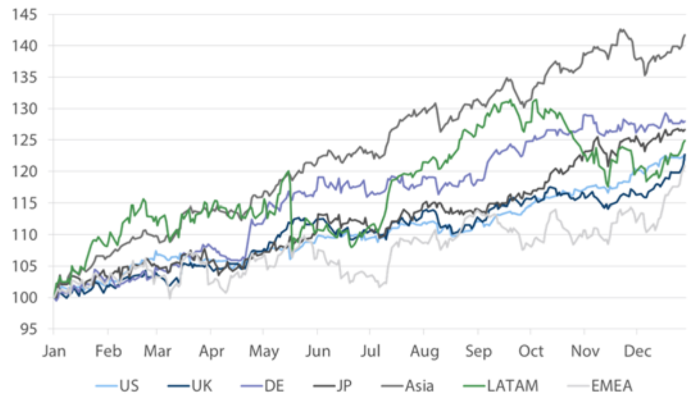
[1]The asset classes or sectors mentioned herein are a reflection of the portfolio manager's current view of the investment strategies taken on behalf of the portfolio managed. These comments should not be constituted as an investment research or recommendation advice. Any prediction, projection or forecast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

Research Views

The hierarchies remain broadly the same from last month. Given the end of year, we decided to take this opportunity to take a look back on some of our views from 2017.

Our **global equities** hierarchy remains unchanged, favouring Japan, Asia and Germany at the top. We started the year with the US at the top of the hierarchy – solid earnings recovery and a positive macro backdrop helped us look through the expensive valuations. However, from May onwards Asia took the top spot, followed by Japan and Germany, which stayed in place until September where Japan edged above Asia to reign supreme. In USD terms, Asia ended the year with the best return, followed by Germany, Japan and the US.

Chart 1: Global Equity Returns in 2017 (USD)



Source: Bloomberg, 2018

The only change this month within equities saw Japan Value become double positive on valuations. Ultra low monetary policy has helped push Japan Growth stocks above Japan Value stocks, with Growth outperforming by over 10% in Yen terms over the year. We have been keeping our eye on Japan Banks, which have suffered thanks to the BOJ's Japanese Government Bond (JGB) yield suppression. However, since September, Japanese Banks have outperformed the broader TOPIX by almost 4%. This was given a push in October when Kuroda warned that bank profitability was declining, acknowledging the rising cost of the BOJ's prolonged monetary easing. We believe the changing view of the BOJ towards a slightly more hawkish stance, on the margin, may help continue this trend and potentially start to see Value outperform Growth in the coming years.

Chart 2: TOPIX Banks vs TOPIX Returns

Source: Bloomberg, 2018

Our **global credit** hierarchy remains unchanged, favouring investment grade (IG) in the US, Asia and Europe. Our credit hierarchy remained practically unchanged over the year. Despite all markets looking expensive, this is considered typical at this stage in the cycle. Solid company profits and improving or stabilising fundamentals saw investors compress corporate spreads. Despite some fears of spill over effects from Asian onshore and Asian High Yield (HY) markets, Asian USD IG has stayed towards the top over the year. Similar yield as US IG but with 30% less duration made the asset class attractive, especially given the headwinds associated with the US Fed tightening policy. Despite solid fundamentals from Japan corporates, we sought returns elsewhere given the very marginal yield on offer. US and Asian IG performed strongly over the year, followed by the EU. Japan IG ended mostly flat for the year.

Chart 3: Global Credit Returns 2017 (Local Currency)

Source: Intercontinental Exchange BofAML, Bloomberg, 2018

On the other hand, we stayed away from HY in general, only favouring US HY at the margin. Late cycle dynamics, deteriorating fundamentals and extremely expensive valuations caused us to be wary. While HY did outperform over the year, the largest outperformance was Asia HY, which outperformed US IG by 1.2%. However, given the growing risks, we still do not believe the minor pick up over investment grade to be worth the risk. We remain more positive US HY but still believe EU and Asia HY are too expensive at this time.

Chart 4: Global High Yield Returns in 2017 (Local Currency)

Source: Intercontinental Exchange BofAML, Bloomberg, 2018

Our **global sovereign bonds** hierarchy remains unchanged from last month, favouring Australia, the US and the UK. Throughout the year we have been cautious on sovereign bonds, primarily due to their expensive valuations and central banks turning more hawkish globally. In those developed markets where central banks tightened monetary policy, such as in the US, Canada and the UK, this hawkishness was felt mostly in shorter maturities resulting in flatter yield curves. Although we certainly acknowledge the importance of sovereign bonds for risk mitigation in any multi-asset investment, it is also important to maximise sovereign yields in the meantime. As such we alternated between each of the three at the top of our current hierarchy throughout the year as opportunities presented themselves. We have stayed away from JGBs and Bunds given the low yields on offer. Any duration sell off would be painful given the lack of yield buffer, despite receiving a yield pickup from hedging. Over the year, Australia, the US and the UK outperformed.

Chart 5: Global Sovereign Returns in 2017 (Local Currency)

Source: JP Morgan, Bloomberg, 2018

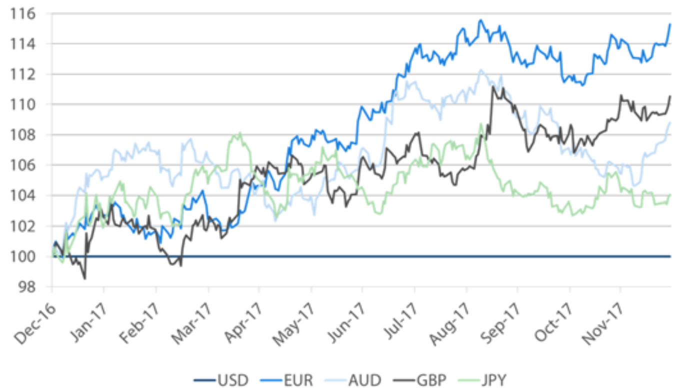
We've typically discussed **Alternatives** in the context of Commodities. However, with an increasing focus on alternative yield sources, we thought it would be time to include Infrastructure and REITs. Infrastructure outperformed REITs significantly over the year, as US REITs were dragged down from the collapsing mall industry. Infrastructure on the other hand continued to pay steady yield over and above most bonds, with the added benefit of increase news coverage thanks to Trump's potential infrastructure push and China's One Belt One Road ambitions. Within REITs, we have been favouring Asian REITs given their high quality issues and growing capitalisation across the region.

Chart 6: Global Infrastructure vs Global REITs

Source: Bloomberg, 2018

We retain our hierarchy for **Global Currencies**. The USD suffered the most during 2017, being outperformed by every currency on the hierarchy. Having spent time at the top of our hierarchy for part of this year, with British Pound (GBP) typically towards the bottom, this call did not go in our favour. Initial thoughts of Fed tightening, potential for inflation, improving trade deficit via Trump's America First policy and foreign capital repatriation led us to believe in a bullish case for the USD. However, the new tax bill may lead to higher deficits, which would be dollar negative. Also, the willingness for global nations to park excess savings in USD is dissipating. China's deliberate policy to internationalise the Yuan will also diminish the dollar's reserve status. These debates will be continued into 2018.

Chart 7: Currencies versus the US Dollar



Source: Bloomberg, 2018

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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