February 2018

Multi-Asset Team

BALANCING ACT

Nikko AM Multi-Asset's global research views

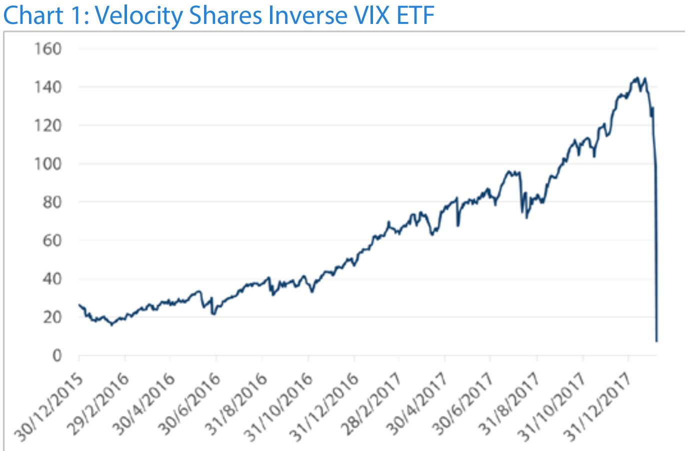
Snapshot

In our 2018 outlook, we made the case for rising volatility as central banks across the developed world slowly remove the stimulus punch bowl, but few would have imagined volatility spiking with such a vengeance as it did in recent weeks. VIX, the index for implied volatility, jumped more than 100% in a single day, in fact in a matter of hours, which had never happened before. Yet it is hard to point to a catalyst that is even closely proportionate to the spike – i.e. there was no "Lehman Brothers" event in sight.

Equities began to sell off ostensibly driven by inflation fears capped by a strong jobs report early in February, but the spike erupted from a "short volatility" ETF, requiring the investment manager to buy volatility (cover their short position) that squeezed the VIX higher in a very short period of time.

These ETFs had grown quite popular in recent years, attracting investors with extraordinary performance. The Velocity Shares Inverse VIX ETF returned 135%, annualised over 2016/17 but then "poof" it went to near zero in a matter of hours.

Chart 1: Velocity Shares Inverse VIX ETF



Source: Bloomberg, 2018

The volatility spike that began with these specialised ETFs was likely amplified by programme trading including risk parity and commodity trading advisors (CTAs) where higher volatility necessarily requires a position unwind. The shock so far appears orderly and contained, unlikely to shake fundamentals, but bears close watching.

Higher volatility is likely here to stay given developed market resolve to tighten. What's more: the US Federal Reserve (Fed) put may be more out of the money than once believed with New York Fed Governor Dudley calling the selloff "small potatoes", perhaps signaling a new era where central bankers are willing to accept higher volatility.

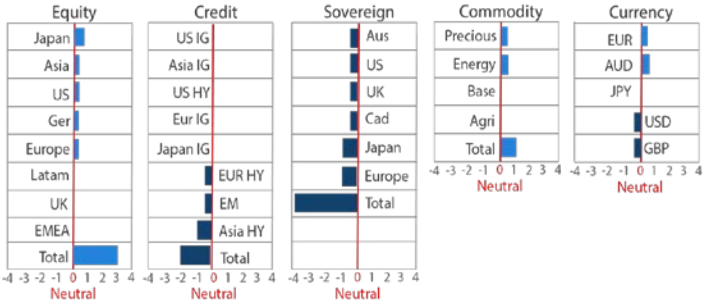
Welcome back to the old normal where volatility is a more fair reflection of actual risk, keeping investors honest as there is no free lunch. Could this be the end of the bull market? We do not think so as fundamentals remain strong, but it will be a rockier road requiring careful portfolio construction emphasising value, quality growth and downside protection where appropriate.

The current high level of volatility is more a distortion driven by programme selling than it is a reflection of true inflation risk. We do expect a rise in inflation, but more of the healthy variety, lifting wages and commodity prices as a function of healthy demand. It is possible that less benign inflationary pressures may begin to build, but the bump-up in yields has already been significant and is a natural stabiliser to reduce inflationary demand pressures.

In our view, the bigger risk is that the return of volatility could destabilise corners of the market that had grown too complacent, forcing further deleveraging. Volatility builds in concentric circles taking out the most leveraged first, but can extend to include those more modestly leveraged, beginning a negative feedback loop with deteriorating fundamentals.

The beauty of rising volatility is that it presents opportunities for those not forced to sell assets (or buy volatility). Programme selling will often leave bargains on the table for fundamental investors to buy, so we cautiously welcome higher volatility while recognising its potential to overshoot and cut into fundamentals.

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

We lifted the US up the **global equities** hierarchy, just above Germany, on the back of a macro upgrade due to strong earnings momentum.

US equities continue to remain expensive though slightly less so after the recent selloff, while momentum remains positive and earnings continue to improve. As shown in Chart 2, the S&P 500 rise is a largely reflection of the forward earnings outlook. After the corporate tax cut late last year, earnings expectations leaped on the prospect for improved margins and the S&P500 followed. These gains were erased in the sell-off, yet the improved earnings outlook is unchanged.

Chart 2: S&P 500 vs S&P 500 earnings forecast

Source: Bloomberg, 2018

Despite monetary tightening in the US, financial conditions have continued to ease – in fact, reaching the easiest levels not seen since 2000 at the height of the last technology boom.

Much of this is due to the dollar remaining weak and credit spreads tight, but we also note that financial conditions can shift quite considerably in a short period of time. To date, the rise in yields, spreads and the dollar have tightened conditions at the margin, but so far conditions remain easy still in support of fundamentals.

Chart 3: Goldman Sachs U.S. Financial Conditions Index

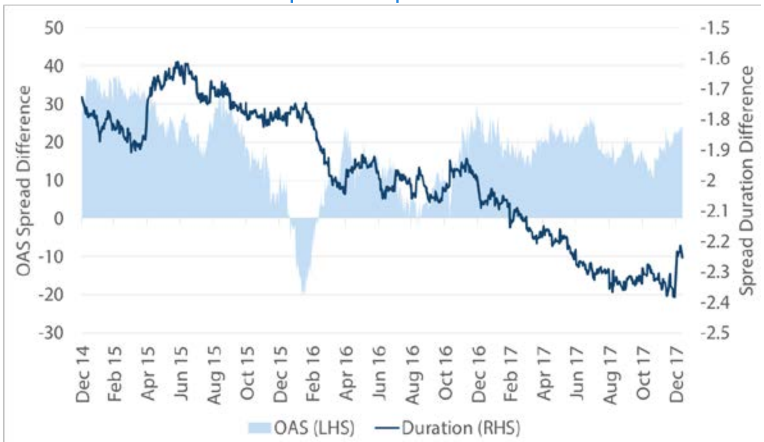
Source: Bloomberg, 2018

Our **global credit** hierarchy remains unchanged, favouring investment grade (IG) in the US, Asia and Europe, with preference for the US within high yield (HY). Credit remains a key asset class to watch closely in the current environment, as concentric circles of volatility often reach lower quality credits. Stress in credit markets is an indication that rising volatility may be feeding back negatively to fundamentals, potentially justifying a reassessment of economic health.

Almost all credit markets are still looking expensive even despite the selloff to date, with little room for further spread compression. However, this is to be expected at this stage in the cycle, as improving global growth and therefore improving cashflow continues to support demand for carry.

Asia IG's option-adjusted spread (OAS) versus US IG is around its three-year average of 24 basis points (bps), but with 2.25 years lower duration, making Asia IG attractive in the current environment of rising yields.

Chart 4: Asia IG vs. US IG Spread & Spread Duration

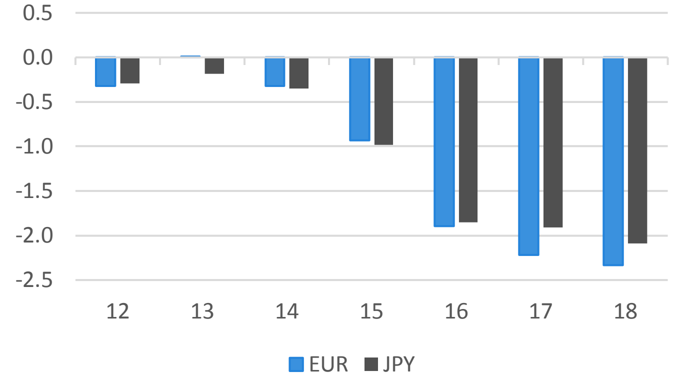


Source: ICE BofAML, Bloomberg, 2018

2018 will be another record year for Asian IG issuance, though redemptions are expected to keep supply contained while local demand is still firmly supported.

USD IG issuance supply is expected to increase, while demand may decrease at the margin as European and Japanese investors are punished by increasingly higher currency hedging costs or a weaker dollar in the case of those choosing not to hedge – a new dynamic described in the sovereign section.

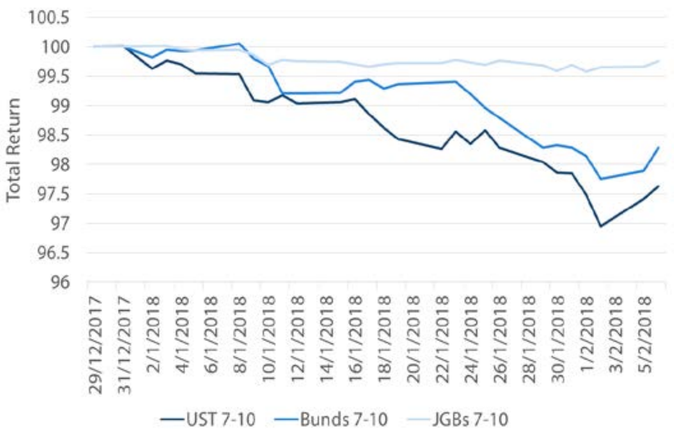
Chart 5: Hedging Costs of USD for EUR and JPY Investors



Source: Bloomberg, 2018

Our **global sovereign bonds** hierarchy remains unchanged from last month, favouring Australia, the US and the UK. Sovereigns suffered a rout throughout the month with US Treasuries taking the brunt of the losses but Germany not far behind, as shown in Chart 6. We have long been cautious on sovereigns due to expensive valuations, negative momentum and monetary tightening especially as reflation is turning to concerns for inflation that is lifting the long end of the curve.

Chart 6: Global Sovereign Returns in January 2018 (Local Currency)



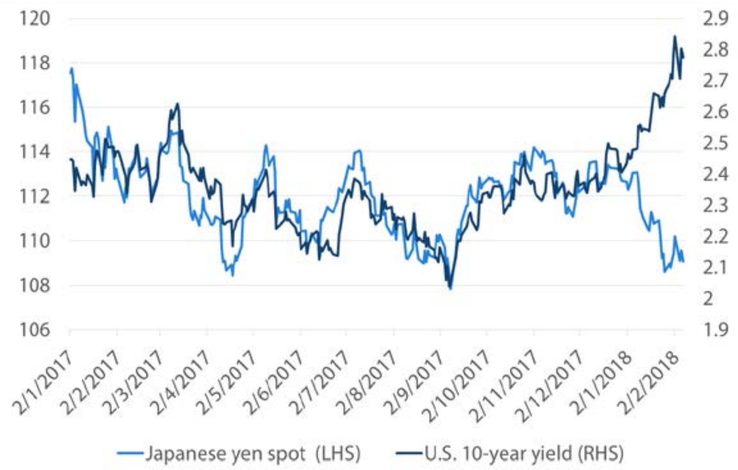
Source: Bloomberg, 2018

Typically, sovereign yields are relatively tethered across geographies where a sizable jump in one tends to mean revert to broader averages given that investors are likely to venture abroad for a more attractive yield.

However, increasing currency hedging costs diminishes the relative attractiveness. Over the past year, a fair contingent of Japan investors chose to own Treasuries unhedged, benefiting from the positive correlation between yield and the dollar.

If you lost money on a rising yield, such losses would typically be mitigated by dollar strength. But this relationship broke down in January where yields rose but the dollar instead also sold off as shown in Chart 7, exacerbating the pain of unhedged exposure.

Chart 7: JPY spot vs US 10-year yield



Source: JP Morgan, Bloomberg, 2018

So long as the dollar and bond yields sell off together, foreign demand for treasuries can remain weak while supply is set to increase not just from recent tax cuts (and potential fiscal stimulus later this year), but also for the reduction in the Fed balance sheet. These supply and demand dynamics are unfavourable, but part of it is currently fear driven, which is likely to dissipate if inflation reports more benign than many seem to fear.

Commodities remain attractive for valuations, momentum and macro fundamentals. As shown in Chart 8, the ratio of commodity prices over the S&P 500 has never been lower all the way back since 1970, indicating strong underperformance relative to equities. One would expect equities to outperform commodities over the long run given real earnings growth, but given that our models show commodities cheap and equities expensive, the potential for mean reversion of this price relationship is high.

Commodities strongly outperformed equities in the 1970s, in a bout of stagflation. The subsequent peaks in 1991 and 2008 were less about inflation and more about demand exceeding supply. In the current environment, inflation looks like it is picking up while supply remains stagnant and demand continues to pick up. The S&P is very expensive, so it is not difficult to see how commodities may have their day soon.

Chart 8: Ratio of S&P GSCI Total Return over S&P 500 Index

Source: Bloomberg, 2018

JPY was upgraded above USD on the **global currencies** hierarchy. For some time, JPY has remained at or near the bottom of the hierarchy for its stated policy of managing the yield curve having the effect of weakening JPY as the Bank of Japan (BOJ) was forced to print money to buy Japanese Government Bonds.

As it turned out, BOJ jawboning did most of the job for them as the stated policy pushed markets to keep yields steady without requiring much in the way of BOJ purchases. In fact, asset purchases declined quite markedly in 2017, below the bank's projections early in 2017.

The asset purchase programme had once seemed focused on weakening JPY relative to the USD in the BOJ's quest to lift inflation while stimulating exports and corporate earnings. However, Japan finds itself increasingly integrated as part of the China supply chain, where JPY strength relative to USD is less relevant. As we have noted for some time, equities have remained resilient despite JPY strength relative to USD.

To date, positioning has been significantly short JPY on the premise that the BOJ's managing its yield curve will result in asset purchases resulting in a weaker JPY. But this is now less the case, leaving JPY stronger at the margin, just as investors are less inclined to currency hedge equity exposure given that equities are more resilient in the face of a stronger currency.

JPY remains inexpensive and with improving momentum supported by these above described dynamics, we lifted it up the hierarchy, just above USD.

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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