BALANCING ACT
Nikko AM Multi-Asset’s global research views

Snapshot
Markets continue to come to terms with the return of higher volatility, triggered ostensibly by fears of inflation and the unwinding of highly leveraged short volatility positions at the beginning of last month. To this list we can now also add the spectre of increasing protectionism and outright Trade Wars.

Volatility will likely remain elevated against the current backdrop of rising economic uncertainty. As shown in Chart 1, global economic policy uncertainty ticked up last month, after several months of decline, post the highs hit in the immediate aftermath of the US presidential election in November 2016.

Chart 1: Global Economic Policy Uncertainty Index

Source: Bloomberg, 2018

However the news is not all bad. Tensions on the Korean peninsula have markedly eased with all concerned parties showing a greater willingness to engage with each other. The protectionist rhetoric coming out of the White House appears to be a case where the bark is proving worse than the bite.

Lastly, fears around the possibly indefinite extension of Mr Xi Jinping’s presidential tenure in China are now also ebbing on recognition that this was neither completely unexpected nor exceptional.

On inflation, we believe the knee-jerk reaction to a strong jobs report in the February misses the bigger picture. Global inflation bottomed out in late 2015 and has been climbing ever since (see Chart 3). In fact on this measure inflation is already above its twenty year average and close to the 2% official target of several global Central Banks. Given strong deflationary forces of technological disruption and globalisation, this would suggest that risks to inflation are more symmetrical than suggested by recent market fears.

The key opportunity that higher volatility offers investors is the ability to add value through active risk taking. This is just as true for top-down allocation as it is for high conviction bottom-up stock picking. We expect markets to continue to be buffeted by strong crosswinds of reflation, geopolitics and shifting risk appetite. In response, our views and portfolios will remain anchored in effective risk diversification and a systematic research process that carefully calibrates signals from proprietary valuation, momentum and macro models.
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

Global equities

A strong earnings outlook helps us stay constructive on equities despite the return of market volatility. We also retain the same relative preferences for markets as last month, with Japan on top and emerging markets (EM) ex Asia and the UK at the bottom.

A stronger Japanese yen (JPY) has weighed on Japan equities recently. However, as noted in a recent report by our Chief Strategist Naoki Kamiyama, we believe volume expansion should continue to support corporate earnings despite JPY strength. As shown in Chart 2, corporate Japan earnings outlook remains among the strongest across global markets. This suggests there may be some margin of safety even if earnings expectations were to be trimmed back marginally.

Chart 2: Consensus Forecast for Earnings growth

At the same time the recent pullback has lifted valuations to positive on our models. The macro outlook is supportive not just for the earnings tailwind but also because monetary policy is still accommodative and fiscal policy remains expansionary. On the former, the reappointment of Mr Haruhiko Kuroda for a second five year term as Bank of Japan (BOJ) governor reinforces continuity in monetary policy. On the latter, the record budget of JPY 97.7 trillion for FY2018 is expected to pass the lower house as scheduled.

Global bonds

We remain cautious on sovereign bonds given expensive valuations, negative momentum and macro headwinds – not least of which is the gradual bottoming of global inflation as discussed in the introduction and shown in Chart 3 below.

Chart 3: Global Inflation - OECD Major 7 Countries

Source: Bloomberg, 2018

We’ve upgraded Canada above the US and UK on our bonds hierarchy. Australian sovereigns remain on top while JGBs and Bunds remain at the bottom, reflecting our preference for yield and central bank outlooks.

One way to compare the expected path of central bank cash rates is to look at the overnight indexed swap (OIS) markets. The 1-year OIS, which is essentially the expected average cash rate over the next year, is shown in Chart 4 below.

Chart 4: 1-Year OIS Rates

Source: Bloomberg, 2018

The US Federal Reserve (Fed) has been steadfast in its resolve to normalise interest rates and this is reflected in the 1-year OIS rate of 1.94% relative to the upper boundary of 1.5% on US Fed Funds. This would indicate that the market is expecting at least 0.75% of further tightening over the next year. We can also see that these expectations have been steadily rising over the last six months.

Canada’s 1-year OIS, however, has been more variable. Expectations for the overnight target rate began to rise from early December last year until last month, mirroring the rise in the US. Canada’s OIS rate has since flattened out, reflecting the notes of caution and patience coming through in Bank of Canada communications around the future policy path.

Conversely, the Australian OIS has been fairly constant, if not falling slightly, over the same period. This reflects market expectations that the Reserve Bank of Australia (RBA) could...
keep its official cash rate unchanged over the next year. It is these divergent monetary policy paths between the US and Canada/Australia that supports our current hierarchy putting both Australia and Canada above US sovereigns.

Our **global credit** hierarchy underwent several changes this month due to changes in valuation and momentum, which saw a net reduction in scores overall. There is no denying that credit is expensive and in certain countries, like the US, quite late in the cycle. Given the tightness of spreads, the underlying sovereign views become more of a determining factor for investment grade (IG) than in the past. The Australian economy remains resilient, with the latest National Australia Bank (NAB) survey showing no signs of concern. Earnings continue to improve, but lack the excitement seen in other parts of the world, such as the US. Australian corporates remain reasonably leveraged when compared to their overseas counterparts and tend to show a perceived resilience when compared to US IG spreads. Local demand remains very strong for AUD paper and supply continues to be limited, especially outside of the financial sector. In short, we see no signs of concern to suggest spread widening any time soon and continue to favour the underlying sovereign risk.

**Chart 5: US IG vs Aus IG OAS Spreads**

Source: Intercontinental Exchange (ICE) BofAML, Bloomberg, 2018

Unlike Australia, we are quite excited about the earnings story and improving fundamentals in Asia and the US, but similarly question how much further spreads can realistically be expected to tighten. However, our expectation is for continued yield appreciation for US Treasuries (UST), making us more wary on USD linked credit. Asia IG has overtaken US IG given its lower duration and therefore lower risk to further rising yields. The US is also further along in the cycle when credit is at greater risk.

We believe Asia is better positioned to benefit from global growth, providing exposure to high growth countries at the earlier stage in their development. While Asia’s credit issuance versus GDP is not too far away from their developed market counterparts, their GDP and therefore their bond market is expected to continue growing. This should lead to deeper and more liquid credit markets within Asia, reducing the need for bank financing, which can be highly cyclical, and further bolstering growth.

Unlike the US, which has seen plenty of demand from ‘yield tourists’ over the past two years, Asian credit remains under-owned by foreign investors, with is over 70% owned by locals. This strong domestic bid has helped prevent spreads from widening despite record issuance over the past few years. Given the increasing wealth accumulated in Asia, along with the propensity to save and invest with a regional home bias, we believe this local bid could continue to strengthen. While Asian IG looks expensive versus its own history, when adjusted for duration and credit quality, it looks attractive versus the US.

**Chart 6: Asia Credit New Issue Allocations**

Source: Bond Radar, JP Morgan, 2018

From a pure spread perspective, Japan IG looks attractive. It is the only credit market whose spread appears cheap. However, even after the pickup from hedging the Yen back to dollars, the overall yield is relatively low and offers limited protection from any potential BOJ taper tantrum. Europe IG (EUR IG) fell further down the hierarchy as momentum turned negative. The European Central Bank (ECB) tapering, while not imminent, has the potential to hurt EUR IG on two fronts – spread widening from reduced credit purchases and rising yields as sovereign purchases reduce. This has pushed most investors down the quality spectrum into HY.

**EM Hard Currency (EM HC) moved further up the hierarchy as valuations improved in Latin America (Latam) and overall value and momentum overall remains neutral. From a spread perspective, we view EM HC quite favourably, but have similar issues with the underlying UST yield risk. However, while not discussed in this section, there is a clear preference for**
emerging market local currency debt, given the relatively attractive real yields and more supportive point in their monetary cycle.

**Commodities**
We retain our constructive view on Commodities as valuations and momentum are both attractive. The macro backdrop remains supportive given rising inflation, constrained supply, growing demand and weakness in the USD with which commodities continue to be strongly negatively correlated.

**Currencies**
Last month we lifted JPY above the USD on the hierarchy as it remains inexpensive and with improving momentum. This month we further lift it to the top while downgrading the AUD two notches down to below the EUR and USD.

The outlook for the AUD has weakened recently through a combination of declining interest rate differentials and global trade concerns. With roughly 40% of Australia’s GDP coming from trade, it is not surprising that recent trade skirmishes between the US and others has caused market participants to re-evaluate prospects for the AUD.

In addition, the AUD has a close correlation to the terms of trade (ToT) as shown in Chart 7. An improving ToT in late 2017 provided support to the AUD, which peaked just above 81 cents, but more recently the ToT has fallen, turning from tailwind to headwind.

![Chart 7: Citi Terms of Trade and AUD](source: Citi, Bloomberg, 2018)

**Process**
In-house research to understand the key drivers of return:

<table>
<thead>
<tr>
<th>Valuation</th>
<th>Momentum</th>
<th>Macro</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quant models</td>
<td>Quant models</td>
<td>Analyse macro cycles with tested</td>
</tr>
<tr>
<td>to assess relative</td>
<td>to measure asset</td>
<td>correlation to asset</td>
</tr>
<tr>
<td>value</td>
<td>momentum over</td>
<td></td>
</tr>
<tr>
<td></td>
<td>the medium term</td>
<td></td>
</tr>
<tr>
<td>Example for equity</td>
<td>Used to inform</td>
<td>Monetary policy, fiscal policy,</td>
</tr>
<tr>
<td>Cape, P/B &amp; ROE</td>
<td>valuation model</td>
<td>consumer, earnings &amp; liquidity</td>
</tr>
<tr>
<td></td>
<td></td>
<td>cycles</td>
</tr>
<tr>
<td></td>
<td>N</td>
<td>N</td>
</tr>
<tr>
<td></td>
<td>Final Score</td>
<td>+</td>
</tr>
</tbody>
</table>
Important Information

This document is prepared by Nikko Asset Management Co., Ltd. and/or its affiliates (Nikko AM) and is for distribution only under such circumstances as may be permitted by applicable laws. This document does not constitute investment advice or a personal recommendation and it does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient.

This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments or participate in any trading strategy. Moreover, the information in this material will not affect Nikko AM’s investment strategy in any way. The information and opinions in this document have been derived from or reached from sources believed in good faith to be reliable but have not been independently verified. Nikko AM makes no guarantee, representation or warranty, express or implied, and accepts no responsibility or liability for the accuracy or completeness of this document. No reliance should be placed on any assumptions, forecasts, projections, estimates or prospects contained within this document. This document should not be regarded by recipients as a substitute for the exercise of their own judgment. Opinions stated in this document may change without notice.

In any investment, past performance is neither an indication nor guarantee of future performance and a loss of capital may occur. Estimates of future performance are based on assumptions that may not be realised. Investors should be able to withstand the loss of any principal investment. The mention of individual stocks, sectors, regions or countries within this document does not imply a recommendation to buy or sell.

Nikko AM accepts no liability whatsoever for any loss or damage of any kind arising out of the use of all or any part of this document, provided that nothing herein excludes or restricts any liability of Nikko AM under applicable regulatory rules or requirements.

All information contained in this document is solely for the attention and use of the intended recipients. Any use beyond that intended by Nikko AM is strictly prohibited.

Japan: The information contained in this document pertaining specifically to the investment products is not directed at persons in Japan nor is it intended for distribution to persons in Japan. Registration Number: Director of the Kanto Local Finance Bureau (Financial Instruments firms) No. 368 Member Associations: The Investment Trusts Association, Japan/Japan Investment Advisers Association/Japan Securities Dealers Association.

United Kingdom and rest of Europe: This document constitutes a financial promotion for the purposes of the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules).

This document is communicated by Nikko Asset Management Europe Ltd, which is authorised and regulated in the United Kingdom by the FCA (122084). It is directed only at (a) investment professionals falling within article 19 of the Financial Services and Markets Act 2000 (Financial Promotions) Order 2005, (as amended) (the Order) (b) certain high net worth entities within the meaning of article 49 of the Order and (c) persons to whom this document may otherwise lawfully be communicated (all such persons being referred to as relevant persons) and is only available to such persons and any investment activity to which it relates will only be engaged in with such persons.

United States: This document is for information purposes only and is not intended to be an offer, or a solicitation of an offer, to buy or sell any investments. This document should not be regarded as investment advice. This document may not be duplicated, quoted, discussed or otherwise shared without prior consent. Any offering or distribution of a Fund in the United States may only be conducted via a licensed and registered broker-dealer or a duly qualified entity. Nikko Asset Management Americas, Inc. is a United States Registered Investment Adviser.

Singapore: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. Nikko Asset Management Asia Limited is a regulated entity in Singapore.

Hong Kong: This document is for information only with no consideration given to the specific investment objective, financial situation and particular needs of any specific person. You should seek advice from a financial adviser before making any investment. In the event that you choose not to do so, you should consider whether the investment selected is suitable for you. The contents of this document have not been reviewed by the Securities and Futures Commission or any regulatory authority in Hong Kong. Nikko Asset Management Hong Kong Limited is a licensed corporation in Hong Kong.

Australia: Nikko AM Limited ABN 99 003 376 252 (Nikko AM Australia) is responsible for the distribution of this information in Australia. Nikko AM Australia holds Australian Financial Services Licence No. 237563 and is part of the Nikko AM Group. This material and any offer to provide financial services are for information purposes only. This material does not take into account the objectives, financial situation or needs of any individual and is not intended to constitute personal advice, nor can it be relied upon as such. This material is intended for, and can only be provided and made available to, persons who are regarded as Wholesale Clients for the purposes of section 761G of the Corporations Act 2001 (Cth) and must not be made available or passed on to persons who are regarded as Retail Clients for the purposes of this Act. If you are in any doubt about any of the contents, you should obtain independent professional advice.

New Zealand: Nikko Asset Management New Zealand Limited (Company No. 606057, FSP22562) is the licensed Investment Manager of Nikko AM NZ Investment Scheme and the Nikko AM NZ Wholesale Investment Scheme.

This material is for the use of researchers, financial advisers and wholesale investors (in accordance with Schedule 1, Clause 3 of the Financial Markets Conduct Act 2013 in New Zealand). This material has been prepared without taking into account a potential investor’s objectives, financial situation or needs and is not intended to constitute personal financial advice, and must not be relied on as such. Recipients of this material, who are not wholesale investors, or the named client, or their duly appointed agent, should consult an Authorised Financial Adviser and the relevant Product Disclosure Statement or Fund Fact Sheet (available on our website www.nikkoam.co.nz).

Kingdom of Bahrain: The document has not been approved by the Central Bank of Bahrain which takes no responsibility for its contents. No offer to the public to purchase the Strategy will be made in the Kingdom of Bahrain and this document is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Kuwait: This document is not for general circulation to the public in Kuwait. The Strategy has not been licensed for offering in Kuwait by the Kuwaiti Capital Markets Authority or any other relevant Kuwaiti government agency. The offering of the Strategy in Kuwait on the basis a private placement or public offering is, therefore, restricted in accordance with Decree Law No. 7 of 2010 and the bylaws thereto (as amended). No private or public offering of the Strategy is being made in Kuwait, and no agreement relating to the sale of the Strategy will
be concluded in Kuwait. No marketing or solicitation or inducement activities are being used to offer or market the Strategy in Kuwait.

Kingdom of Saudi Arabia: This document is communicated by Nikko Asset Management Europe Ltd (Nikko AME), which is authorised and regulated by the Financial Services and Markets Act 2000 (as amended) (FSMA) and the rules of the Financial Conduct Authority (the FCA) in the United Kingdom (the FCA Rules). This document should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko AME.

This document does not constitute investment advice or a personal recommendation and does not consider in any way the suitability or appropriateness of the subject matter for the individual circumstances of any recipient. In providing a person with this document, Nikko AME is not treating that person as a client for the purposes of the FCA Rules other than those relating to financial promotion and that person will not therefore benefit from any protections that would be available to such clients.

Nikko AME and its associates and/or its or their officers, directors or employees may have or have had positions or material interests, may at any time make purchases and/or sales as principal or agent, may provide or have provided corporate finance services to issuers or may provide or have provided significant advice or investment services in any investments referred to in this document or in related investments. Relevant confidential information, if any, known within any company in the Nikko AM group or Sumitomo Mitsui Trust Bank group and not available to Nikko AME because of regulations or internal procedure is not reflected in this document. The investments mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors.

Oman: The information contained in this document neither constitutes a public offer of securities in the Sultanate of Oman as contemplated by the Commercial companies law of Oman (Royal decree 4/74) or the Capital Markets Law of Oman (Royal Decree80/98, nor does it constitute an offer to sell, or the solicitation of any offer to buy non-Omani securities in the Sultanate of Oman as contemplated by Article 139 of the Executive Regulations to the Capital Market law (issued by Decision No. 1/2009). This document is not intended to lead to the conclusion of any contract of whatsoever nature within the territory of the Sultanate of Oman.

Qatar (excluding QFC): The Strategies are only being offered to a limited number of investors who are willing and able to conduct an independent investigation of the risks involved in an investment in such Strategies. The document does not constitute an offer to the public and should not be reproduced, redistributed, or sent directly or indirectly to any other party or published in full or in part for any purpose whatsoever without a prior written permission from Nikko Asset Management Europe Ltd (Nikko AME). No transaction will be concluded in your jurisdiction and any inquiries regarding the Strategies should be made to Nikko AME.

United Arab Emirates (excluding DIFC): This document and the information contained herein, do not constitute, and is not intended to constitute, a public offer of securities in the United Arab Emirates and accordingly should not be construed as such. The Strategy is only being offered to a limited number of investors in the UAE who are (a) willing and able to conduct an independent investigation of the risks involved in an investment in such Strategy, and (b) upon their specific request.

The Strategy has not been approved by or licensed or registered with the UAE Central Bank, the Securities and Commodities Authority or any other relevant licensing authorities or governmental agencies in the UAE. This document is for the use of the named addressee only and should not be given or shown to any other person (other than employees, agents or consultants in connection with the addressee’s consideration thereof).

No transaction will be concluded in the UAE and any inquiries regarding the Strategy should be made to Nikko Asset Management Europe Ltd.