AXA INVESTMENT MANAGERS

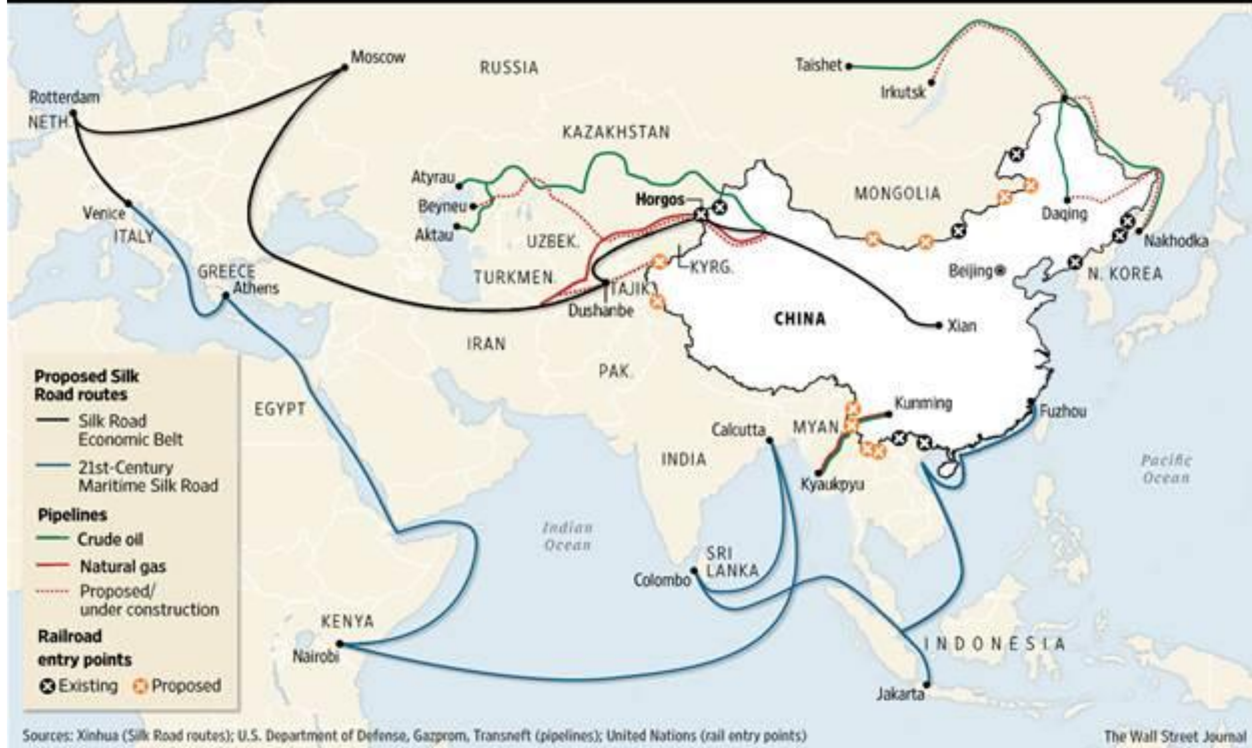
By ***Mark Tinker, Head of AXA IM Framlington Equities Asia***

- Flows are dominating fundamentals at the moment as institutions reduce risk by buying back underweight positions in so called high risk areas such as emerging markets.
- Interest in Asia appears very high, and largely constructive. A big conference week in Hong Kong last week was more focused on how capital flows are going to affect the real world rather than obsessing about financial market trading noise.
- By contrast, Japan appears to be seeing capitulation by foreign investors and the yen looks to be the trigger as most foreign money was hedged and thus short yen.

Last week was particularly busy in Hong Kong with the traditional pre-Rugby Sevens conferences. Several investment banks and independent research houses held conferences and seminars to capitalise on the network effect that was originally based on visiting international investors looking to tag the Rugby Sevens onto the end of a Far East research trip. A large number of company C-suite management teams were in town and almost all of the investment team here in Hong Kong were busy at meetings for most of the week. Nowadays the networking, corporate meetings, conference speeches and seminars are more important than the rugby for the investors. Although thanks to Rugby Sevens being a new Olympic sport this year the quality an interest in the Sevens is at all-time highs – and all of the events were packed out. Indeed, on several occasions for some of the macro presentations I couldn't even get into the room!

It seems clear to me that **interest in Asia has definitely picked up again**, not just based on the packed conferences, but more generally the mood, it appears that people are starting to become more constructive on the opportunities here. This partly reflects the **local real world opportunities** many are now hoping to see for Hong Kong financial services, in particular as the 'One Belt One Road' (OBOR) initiative begins to gather momentum. The scale of the project is to be measured in decades and in trillions and while there remains much to be done even at the planning level, what seems certain is things will start happening, and soon.

'One Belt One Road' – will drive trade and (re)connect China with the rest of the world



There was a lot of discussion last week about how Hong Kong’s professional and financial services sector can facilitate, participate and of course profit from these iniatives. There was also **much interest in the newly forming Asia Infrastructure Investment Bank (AIIB)** which most agree will be key in helping fund the OBOR initiative. There is still a huge financing gap between the projects planned and the money needed to finance them. However, unlike the west where this is often (and correctly) seen as an insurmountable obstacle that leads to projects being shelved, here the talk is of how, rather than whether or not that gap will be closed. The role of the AIIB in not only providing funding but perhaps also in providing some form of credit insurance for investors wishing to invest in some of the infrastructure projects where the underlying sovereign might not be judged a suitable credit.

More broadly of course, the key role of China in this means that much of it will be funded through renminbi (RMB), as increasingly China seeks to trade in its own currency, rather than in US dollars. In addition **many of the panel discussions around vaious conferences this week were back to discussing the RMB as a tool for trade rather than as a speculative counter**. In this area I see parallels from 1970s Europe, where the deutsche mark (DM) gradually replaced the US dollar as the major trading currency for the continent, prior of course to the creation of the Euro. Opening up the Chinese capital account was discussed as something that China was going to do to facillitate its trading links rather than something that western traders were ‘demanding’ it do in order to access western financial markets. As I have said on many occasions, from where I sit (literally) it seems clear to me **that China is genuinely interested in accessing long term capital flows** from the west, not least to help it properly price long term capital assets. What it has **no interest in however is letting short term speculative flows destabilise its monetary policy and by extension the economy**. Despite the huge short squeeze for the sell China bears, a lot of the international visitors I talked to last week still had a core belief in the ‘need’ for a devaluation of the RMB even as the locals had moved

on. Economists are fond of referrring to the problem China faces with the **“impossible trinity**”, the expression made popular by economists Robert Mundell and Marcus Fleming back in the 1960s about the inability to control interest rates, exchange rates and the capital account at the same time and it is the experience of previous countries and the subsequent devaluations that is behind much of the belief (particularly in the US) of the ‘inevitability’ of a RMB devaluation. George Soros for example made his first big fortune exploiting the impossible trinity as it referred to the British pound during the exchange rate mechanism (ERM) crisis of 1992 and subsequently even more betting against emerging market currencies like the Thai baht and the Malaysian ringett during the EM crisis of 1997/98. As such it is perhaps not surprising that he is one of the louder voices declaring a need for a much weaker RMB. However, as one of the presenters in town last week – a former head of the China Banking Regulatory Commission - pointed out, **China does not actually face this problem** as it is not trying to control all three at the same time. It is easing the capital account, but in a way that it can tighten up capital flows should it see fit, it is targeting a basket of currencies, not just a dollar peg, and it has a wide variety of tools for controlling its economy, not just interest rates. Indeed, in his view it was much more likely that fiscal tools would be used to direct the economy in any event. The fact that China has a large savings rate and a huge pool of existing savings means that unlike other emerging markets it does not ‘have to’ rush the opening up of its capital account and the desire is to allow long term capital flows in either direction but with control valves.

One other country that also has excess savings is Japan and ironically it is the very open nature of its capital account that is causing such **disruption in the yen and the Japanese stock market at the moment.** As the chart below from Credit Suisse shows, the start of the Abenomics experiment in late 2012 led to a significant upturn in foreign buying of Japanese equities.

Chart 1: Foreign fund flows heavily influence the Nikkei 225

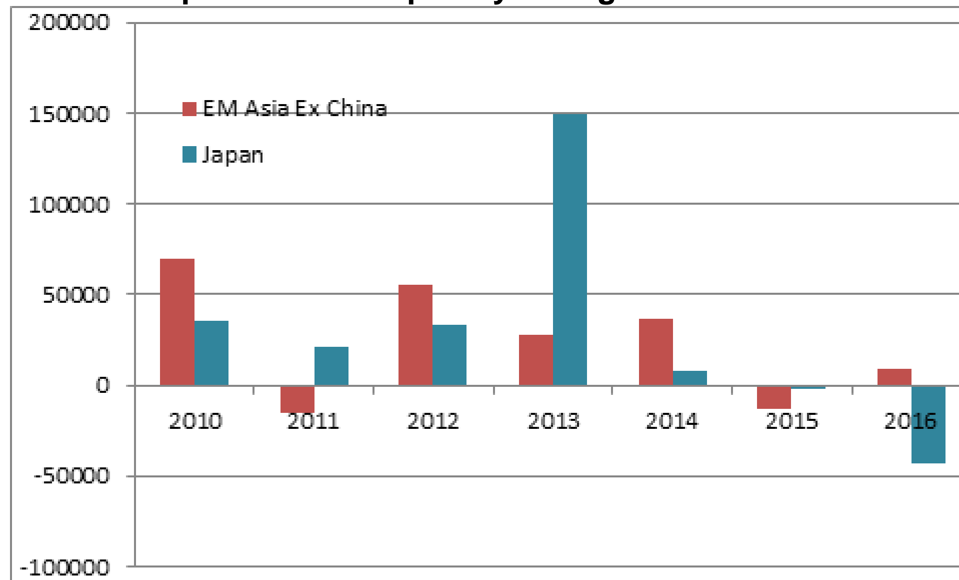
Figure 4: **Net foreign buying/selling in Japan vs. Nikkei 225**

Source: Various stock exchanges, Bloomberg, Datastream

However, the cumulative 12 month net buying has now turned negative, running at around 1% of market cap on a rolling 12 month basis, worse than in July 2012 and approaching the depths seen in early 2009. This looks to be the latest hit from the capitulation shockwave and flows are dominating fundamentals at the moment. If we look at the data gathered by Credit Suisse from various stock exchanges we can

compare flow in and out of EM Asia ex China with those into Japan over the last five years.

Chart 2: Capitulation in Japan by Foreigners



Source : Credit Suisse, AXA-IM

Prior to Abenomics, EM Asia Ex China tended to dominate flows, but the huge inflows in 2013 not only led to indigestion in 2014, 2015 but now **already this year have seen outflows at an annualized run rate close to the inflow rate of 2013. As previously discussed, the problem looks to be associated with yen hedging**. Almost all of the inflows in the Abenomics boom would have been yen hedged, because in effect this was the quantitative easing (QE) playbook – currency falls, equity market goes up. Of course when the yen rallied in January against a consensus for further falls, the trade was hurriedly taken off, leading to more yen strength and more selling of hedged equity positions by foreigners and so on. It is difficult to know how much more there is left to go, with the yen and Nikkei being one of the few inverse correlation/momentum trades available at the moment it is likely that there is now some speculation building that could rapidly unwind, much as the 'sell China' trades snapped back from mid-February. Certainly fundamentals point to Japan being cheap and if anyone is buying back into emerging markets as a cyclical play on stronger growth in the US, China etc. then Japan is probably best placed of all the major markets. For now though, there is another one of those buyers' strikes underway.

One of the subjects that generated the most discussion here in Hong Kong last week was not on any of the official presentations - it was Brexit. As discussed here previously this is, in my opinion, likely to be the key story for Q2 risk management and despite having a poll rating probability not too far from a 50:50 chance, it is a (fat) tail risk that nobody is really hedging. Well, to be fair, some are trying, selling sterling being the most obvious, but other ideas were being thrown around last week such as buying UK dollar earning stocks and selling UK property companies and financials. We can see sterling implied volatility spiking and UK credit default swap (CDS) protection prices jumping and some movements in investment grade euro credit and investment grade sterling credit spreads taking them close to 2009 highs.

What is interesting at the moment though is that nobody seems to be doing much for pricing any impact on the residual eurozone. If there were to be a vote to withdraw,

there would of course need to be negotiations on negotiations about exactly how to trigger the process and a lot more negotiations about trade and so on. However, what could happen straight away is that people would focus on the finances; who would pick up the UK share of the funding? The European Union (EU) claim that it is very difficult to calculate exactly what the net benefits are, but the very fact that the UK contributes around 12.5% of the gross budget would likely make a lot of **countries that are currently net beneficiaries suddenly have to become contributors** – something which tends to make voters less positive about being members of a 'club'. The fact that countries like the Netherlands and Denmark who are mainly in the (small) group of net contributors due to the high volume of port traffic passing through their countries – itself a side effect of the Rotterdam effect that also inflates the apparent trade the UK does with Europe - would then also be asked to pay more from 'real' funds would likely put pressure on these two 'core' countries as well. Denmark is probably the most semi-detached member of the EU after the UK and recently voted for no more integration into Europe, but there will also be concern about the various secessionist parties in Spain, Scotland and others. Meanwhile, the Greeks will shortly be back to the table reminding us all of their ongoing need for funding and refinancing. As I said at the start of the quarter, **it is probably worthwhile buying a bit of option protection.**

On the actual probabilities, there are some interesting statistics being thrown around by some of the analysts in Europe including the fact that the people most likely to vote leave are in the older age brackets and importantly they are also the most likely to actually turn out to vote based on past behaviour. This could be the aim of the so called 'project fear' tactics of the 'remain' campaign, to try and get the participation up from young people. Meanwhile the fact that the vote will be taken during the Glastonbury Festival is being seen as taking out thousands of potential 'remain' voters, while to compound the touted conspiracy theories, England's last game in the group stage of the European Championships, against Slovakia will be over by Monday 20th June. Indeed, with an Englishman, Danny Willets a 60/1 outsider winning the US Masters last weekend and Leicester City, who were 5000/1 against winning the Premier League at the start of the season, currently seven points clear, there is perhaps a case to be made for betting on Brexit and England winning the European Championship (currently 10/1). I am happy to defer to our CIO of Fixed Income, Chris Iggo, on football matters however!

Finally, before the Easter break we discussed the growth in Asian corporate bond markets and in particular the important changes underway in China. There is much discussion over Chinese debt levels, but it is essential to recognise two things about the debt a) it is largely 'onshore' and b) it is still almost entirely with the traditional banking sector.

There are, nevertheless, currently sufficient bonds in the investable universe to already have an investment fund and **it is worth highlighting the success of my fixed income colleagues here in Hong Kong with their Asian short duration strategy, which hit its first anniversary a couple weeks ago**. The economic case is a simple one: in Asia we have high credit spreads, low default rates and a strategy that targets 90% of the investment universe yield with half the volatility. These fundamentals plus a strong sector allocation strategy have meant that in its first year the strategy has achieved its aim of beating many of its peers and becoming one of the best performers in this space. The fact that this was achieved with even less than half the volatility is even more impressive in my view.

To conclude, the second quarter has begun with traders looking to technicals and

momentum to try to work out where to push next and have clearly settled on Japan. The huge inflows into the Nikkei in 2013 were almost all hedged back into the dollar and as such the strength of the yen is working to trigger capitulation, which in turn is driving both the yen higher and the Nikkei lower. History, including recent history on capitulation in emerging markets and commodities tells us this can take a while to settle, but ultimately fundamentals will reassert. To me it looks like the Japan trade has reached the level where a capitulation has been followed by a buyers' strike, which leaves room for the speculative traders to short equity and go long yen. This can extend for a period, but then can snap back sharply – as in February and March with emerging market currencies bonds and equities. At some point the value investor appears, the buyers' strike switches to a sellers' strike and it all rotates again. With attention shifting to Europe and Brexit over the next two months it may well be that a break of the inverse correlation between Nikkei and yen is the trigger – i.e. the yen remains strong because of concern about the euro, but value investors buy Japan equity, which in turn triggers short covering as the currency/equity pair trade unwinds. Certainly Japan fundamentals, valuation and exposure to Asia growth all continue to play in a positive fashion. Meanwhile, Asia appears to be attracting interest from genuine long term investors focusing on real cash flows and real world economics as opposed to carry trades and leveraged structures. This is true in both equity and corporate bonds and is, in my opinion, very healthy.

Regards,

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Notes to Editors

All data sourced by AXA IM as at Thursday 14 April 2016.