Multi-Asset perspectives

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February 2021

Market Summary

Macro

- **Global COVID cases** rose to 114 million. The 7-day average of daily new cases dropped to 40% of its peak (806k) but was 6% higher than the mid-month low, with increases in continental Europe, Brazil, India, and smaller countries. Our Global Stringency Index that uses Oxford data, was down a notch from 72 to 69 (100=highest stringency) on increased reopenings in US, China, and Mexico. Europe moved in the other direction. Global vaccinations hit the 240m mark, with Israel having administered doses equivalent to 87% of its population count.
- **Economic recovery stayed on track.** Global manufacturing outlook remained robust with our global Manufacturing PMI index touching a 3-year high. Global industrial output grew @3.1%yoy in Dec'2020. Global Macro-economic surprises were positive for a tenth successive month and corporate earnings estimates ticked up further. Financial conditions were easy and stable. Prospects of a large fiscal boost in the US are rising. Reopenings will pick up as larger shares of global population get vaccinated, shifting pent-up demand from goods to services.
- **Global inflation** was stable at 1.1%yoy (3m average) in Jan'2021, though the Jan'2021 reading (1.3%) was higher than Dec'2020 (1.1%). Both market-traded inflation swaps and PGAA's leading indicator predict inflation moving higher.
- **Higher volatility** in bonds pulled up our cross-asset implied volatility indicator, though levels remained benign by historical standards.

Bottom-up

- MSCI AC World's **expected EPS growth** for the year 2020 eased to -15% yoy on strong corporate earnings for 4Q'2020. 2021 growth was stable at 27%yoy. Earnings revisions remained positive.
- The ratio of **global credit rating upgrades to total changes** was at 47% (19% end-2021). Bankruptcy filings in the US are declining too.

Valuations

- **Equities stayed expensive on earnings-based measures.** A few markets were cheap on P/B. Very low nominal and real rates, recovering growth and promise of policy support can prolong market richness.
- **IG and HY** spreads remained expensive.
- **US 10-yr treasuries** were expensive but their expensiveness has reduced in recent months.

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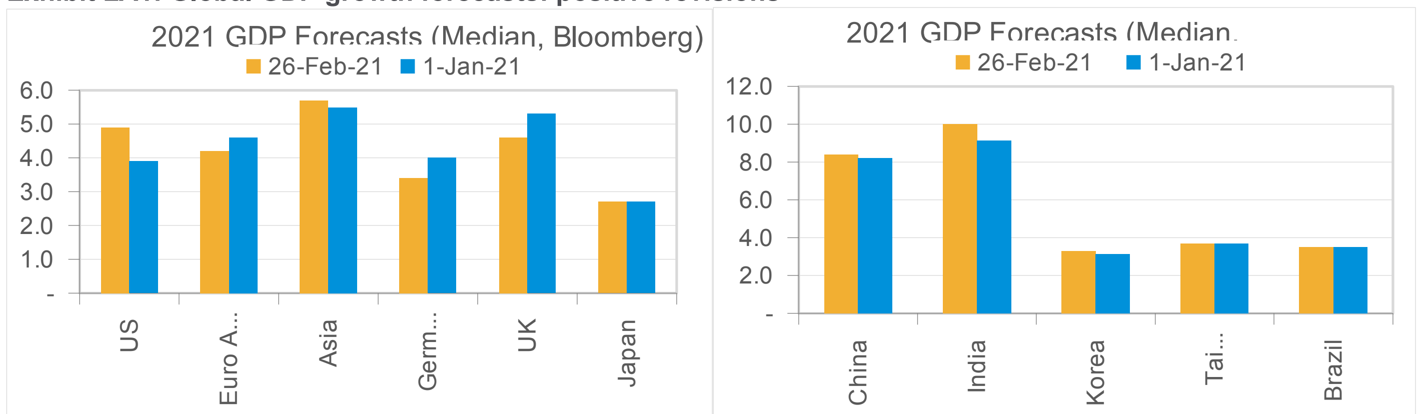
Markets

- **Multi-Assets:** Our global multi-asset index returned 0.8% in Feb'2021 to tip YTD'2021 return into positive territory at 0.3% (last 12-month returns were strong at 16.7%). Commodities led (↑11%). Equities were positive too. HY was flat while Sovereigns & IG fixed income detracted.
- **Equities** finished with positive returns but below intra-month highs on worries about higher yields. 34/40 markets we track finished in the green, with a median local currency return of 2.7%, taking median YTD'2021 return to 2.1%. Return patterns had a strong cyclical bias, with Small Caps, Value, Energy, Financials and Materials outperforming.
- **Fixed income:** While policy rates remained low, sovereign yields shot up (PGAA's Global Sovereign 10-yr yield indicator ↑31bps to 2.36%). Markets continued to price higher growth/inflation against a supportive monetary backdrop. Credit spreads tightened. Bond returns were mostly negative, with 'Up-in-Yield, low-in-Duration" exposures outperforming.
- **Currencies:** US$ finished stronger against EMs in a month of contained volatility: It gained against 22 of the 30 currencies we track it against. Support came from higher real and nominal US yields, stronger US growth and populist follies by some EM countries like Brazil.
- **Commodities:** The GS commodity index gained 11%, finishing above end-2019 levels and completing its pandemic round-trip! Energy (17%) was the big gainer while precious metals continued to suffer drawdowns. Speculative open interest in the eight leading commodities we track continued to rise.

Outlook

1. **Growth**
   The global economy continues to recover from the COVID-19 related shock, aided by loose monetary and fiscal policies. We were expecting a softer first quarter on prolonged lockdowns in Europe but that risk is fading on continued strength in global manufacturing and the front-loaded nature of the $900bn US Emergency COVID Relief Act spending, which is causing US consumption to pull well above trend (Retail sales were up 7.4%yoy in Jan'2021). While there could be some hit on activity from extremely cold weather in parts of US in Feb'2021, US personal savings have swollen to $3.9 trillion as of 1/31/2021 (savings rate of 20.5%), which will make this hit temporary at best. The additional $1.9 trillion fiscal spending package provides further upside to US growth. Our base case US real GDP growth expectation of 4.8% in 2021 is moving towards our bull case around 6%. While the outlook for Europe is marginally dimmer, disbursements under the Euro Recovery fund should help weather the hit from an extended lockdown and a slow pace of vaccination. The two Asian giants China (8.4%) and India (10%) will grow well above trend. However, there exist several risks that could slow the recovery.

Exhibit LA1: Global GDP growth forecasts: positive revisions



Source: Bloomberg/Factset/Principal Global Asset Allocation; India's growth is for fiscal year ending March 2022.

2. **Inflation**
   Our Leading Indicator continues to predict higher headline inflation in 2021, powered by higher commodity prices but it is not likely to be sufficient to push core inflation towards levels that push developed market policymakers to turn prematurely hawkish. 10-yr CPI Swaps are already pricing inflation @ 2.3% in US, 1.3% in Germany, 3.6% in UK and 2.2% in Australia, which leaves little room for meaningful upside, unless markets start moving towards a structural repricing of inflation, driven by a loose monetary-fiscal mix that lasts a long time, and significant supply-side constraints (tight labor market and restrictions on movement of labor and goods). We assign a small probability to such a possibility at this point. For EMs, while higher oil and food prices are a headwind, given higher weights of food and energy in their inflation baskets, most of them still have room to absorb higher prices before having to take policy action to constrain inflation.

3. **Monetary policy & global financial conditions**
   This has been the most talked about topic in recent weeks. Global monetary policy remains extremely easy but the future path has admittedly become a little more uncertain. Given where growth and inflation are, we don't expect any more rate cuts, with balance sheet and forward guidance used as primary tools to conduct monetary policy over the next year or so. Steeper curves have increased the market-implied probability of rate hikes. Euro$ futures show US$ libor reaching 44bps by 2022 and 109bps by 2023 as opposed to Fed's forward guidance of staying unchanged at current levels (0.125%) through 2023. They also imply a Fed funds rate of 2.5% (the FOMC-projected terminal funds rate) by end-2028 and breaching it the year after. The US treasury curve shows the 10-yr forward 10-yr yield at 2.90%, which in the context of Fed's long-term target of 2% inflation, pegs the forward real yield at a healthy 0.90%. We think the chances of Fed action at the long end are rising through an increase in the weighted-average maturity of their purchases, particularly if real yields continue to rise. ECB and BoJ will remain dovish for a prolonged period, given the much longer distance they must travel to get to inflation goals. EMs, however, could face a conundrum, with some central banks (Brazil in particular) being forced to recalibrate domestic policy settings tighter in response to higher inflation.

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4. **Valuations**
    - We remain in a world of scarce risk premia, starting with cash and extending to most forms of corporate risk.
    - **Anti-fragile assets** like global safe-haven treasuries remain expensive though less so than a few months back.
    - **Equity** valuations remain rich. Recovering growth and depressed safe haven nominal/real bond yields continue to incentivize equitization of savings no doubt, but valuations should start normalizing as the recovery matures and as interest rates normalize further. However, if growth exceeds expectations, either on its own accord or induced by stimulus, the valuation normalization could be delayed.
    - **Corporate spreads** too are in an expensive zone, though less so than equities. With most spreads close to cycle lows, room for them to compress further has reduced.
    - In **Currencies,** the US$, is still a little expensive. An essential condition for the US$ to weaken further is stronger growth recovery outside the US, which will move money into under-owned assets in Emerging economies and ex-US developed markets. A risk-off move, however, will bring investors back into the safety of the US$.

5. **Sentiments & technical indicators**
    Flows into equities suggest animal spirits are back. Retail participation in markets is high, and risk positioning remains extended, though some froth was taken off from systematic strategies in Feb'2021.

6. **Summarizing our thoughts on risk assets:** We retain a pro-risk stance in our asset allocation framework, even as we recognize the compressed risk premiums. Our checklist of various factors stacks up as under-
    a. **Return-to-Work strategies:** Rising vaccinations are beginning to help the reopening process which will ultimately boost high contact activities like travel, dining out, leisure etc. Stringency seems to be topping out. New infections seem to have peaked too. Overall, this factor has turned **"positive"** from neutral.
    b. **Growth:** Both macro and bottom-up growth environments continue to improve. Buffer with savers and increased chances of a fresh stimulus in US have caused us to move this factor to **"positive"** from neutral in the short-term. The medium-term outlook remains **"positive"**.
    c. **Monetary policy** – Central banks still seem "worried", which is good for asset markets. However, we realize that as growth normalizes, settings could change to being less accommodative at the margin, causing us to shift this factor from **"extremely positive"** to **"positive".**
    d. **Fiscal policy** – The proposed US fiscal stimulus, provides upside risk to growth. Overall, we rate this factor as **"extremely positive"** in the near term. The medium-term outlook remains **"positive"** but could be clouded by the possibility of higher taxes down the road.
    e. **Valuations –** Low risk premiums worry us, but the lack of meaningful returns from risk-free alternatives should keep investors interested in equities and corporate risk assets as long as the forward-looking growth outlook is strong. While valuation factors don't necessarily play out in the short-term, we are cognizant of risks, which causes us to keep this factor at **"negative".**
    f. **Technical factors:** Technical indicators are stretched which makes us keep this factor as **"negative"** in the near term.

7. **Key risks**
    The key risks to our pro-risk allocation stance are-
    - Premature fiscal/monetary policy tightening is a key risk globally and particularly in countries like China which seem to be moving towards a more prudent fiscal/monetary approach than stimulation at all costs.
    - Vaccine disappointments, either because people don't take it or because it isn't successful in restraining mutated strains of the virus.
    - The technology sector could face headwinds as regulators try to reign in large-cap technology companies.
    - Higher corporate taxes as OECD progresses in plugging loopholes in the global tax system including a global digital tax.
    - US-China relationship takes a turn for the worse.
    - European elections could throw a curve ball as Scotland (May), Germany (Sep) and France (2022) head to polls.

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The piece was written with contributions from Han Peng, Raj Singh and Scott Payseur

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