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Multi-Asset perspectives

Courtesy of Principal Global Investors

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April 2021

Market Summary

Macro

- **Global infections** rose **to 152 million** by end-Apr'2021. The 7-day average of new cases jumped to a new high of 812k, 228k higher than at the end of Mar'2021. India (a jump of 303k) contributed the most as a highly infectious virus mutant hit it hard. US (-17k), Europe (-22k), smaller EM countries (-27k) all saw fewer cases. **Global Fatalities** rose **to 3.2 million**. The global mortality rate was down one-tenth to 2.1%. **Our Global Stringency Index** that uses Oxford data, deteriorated to 66 from 60 (100=highest stringency) on increased lockdowns in India (58 to 74), China and France. **Global vaccinations** gathered momentum. The global vaccination count reached 1.15bn. 540m new doses were administered in Apr'2021 vs. 350m in Mar'2021. Israel has administered 113 doses per 100 residents. UK and US were at 74 each. Vaccine passports are upon us.
- **Economic recovery stayed on track**. US fiscal spending is pushing growth estimates higher. Global manufacturing outlook remains strong. Our global Manufacturing PMI dipped slightly but remained elevated. Global industrial output grew 7%yoy in Feb'2021, a tad lower than January's growth of 8.5%yoy. Global Macro-economic surprises were positive for a twelfth successive month. Corporate earnings estimates ticked up and 1Q'2021 reporting season got off to a solid start. Global Financial conditions remained easy.
- **Global inflation** rose to 1.5%yoy (3m average) in Mar'2021, with Mar'2021 reading (2%) higher than Feb'2021 (1.4%). **Our leading indicator continues to project higher inflation through 3Q'2021 before tapering down.**
- **Our cross-asset volatility indicator** remained below its long-term average, supporting conditions for risk-taking.

Bottom-up

- MSCI AC World's **expected EPS** CAGR for 2021-22 edged up to 22% from 20%, with 2021 at 34% and 2022 at 11%.
- The ratio of **global credit rating upgrades to total changes** edged up to 51% (19% end-2021) as upgrades outnumbered downgrades in the high yield space.

Valuations

- **Equities stayed expensive on earnings-based measures.** A few markets were cheap on P/B. Low real rates, strong growth and continued policy support can sustain the richness. US remained expensive versus ex-US.
- **IG and HY** spreads remained expensive.
- **US 10-yr treasuries:** Our time-trend model pegs US treasuries closer to fair value after upward movement in yields in the last 12 months.

Markets

- **Multi-Assets:** Our global multi-asset index returned a strong 3.1% in Apr'2021 to push 1Q'2021 return to 3.7% (the last 12-month returns remained astronomical at 27.7%).
- **Equities** finished with strong returns yet again. 31/40 markets finished in the green with a median local currency return of 1.4%, which took median YTD'2021 return to 7.5% with 32 markets in the green. US led while India and Japan underperformed. EMs lagged DMs. Momentum and Growth styles outperformed.
- **Fixed income:** While policy rates were broadly unchanged, PGAA's Global Sovereign 10-yr yield indicator ended -4bps lower at **2.5%** as yields consolidated after rising 67bps in the past 12 months. Credit spreads tightened modestly. Bond returns were positive, driven by lower yields, tighter spreads, and favorable FX effects (US$ weakness).
- **Currencies:** The US$ rally paused after a robust showing in 1Q'2021. While themes of divergence i.e. stronger US growth vs other DMs and a faster path towards monetary policy normalization were $ supportive, rich valuations, the pause in rise in real US yields, and surging US fiscal and current account deficits combined to pause the $ advance.
- **Commodities**: The GS commodity index was up 8%, with widespread gains (there was hardly a commodity that didn't rise). It took YTD'21 return to a huge 24%. Speculative open interest increased, as did net length.

Outlook

1. **Growth – an upgraded outlook**
   The global economy continues its recovery from the COVID-19 related shock, aided by extremely supportive monetary and fiscal policies, and rising vaccinations that raise the prospects of a meaningful economic reopening by 3Q'2021, at least in countries that are ahead on the vaccination drive. American households are sitting on record savings, driven by large social transfers from their Govt. The Mar'2021 savings rate was 27.6% and $6 trillion resided in savings accounts, which provides a strong base for increased consumption spend over the next several quarters. Our Economic Committee had already upgraded its US economic outlook recently, riding these factors. Higher US demand is likely to show up in global activity too, with OECD estimating GDP growth impact at 3.8% from the American Rescue Plan's $1.8 trillion spend. Canada (1.2%), Mexico (0.8%), Brazil (0.6%), Euro Area (0.5%) and China (0.5%) will also benefit from that spend. Outside the US, Emerging Markets like China (8-9%) and India (10-11% though risks are to the downside) will grow strongly. However, there exist several risks that could slow the recovery.

Exhibit LA1: Social transfers powering US savings

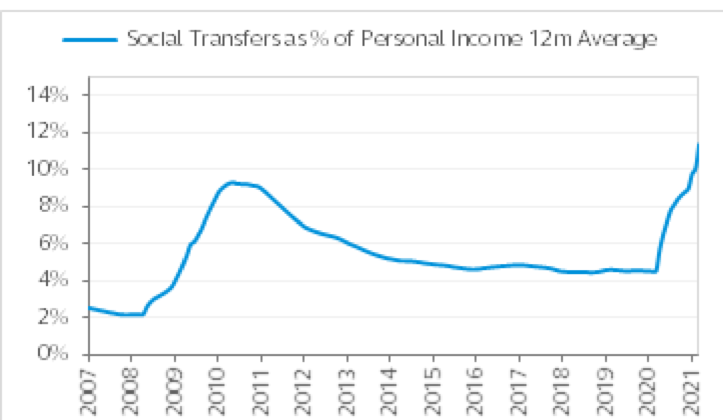
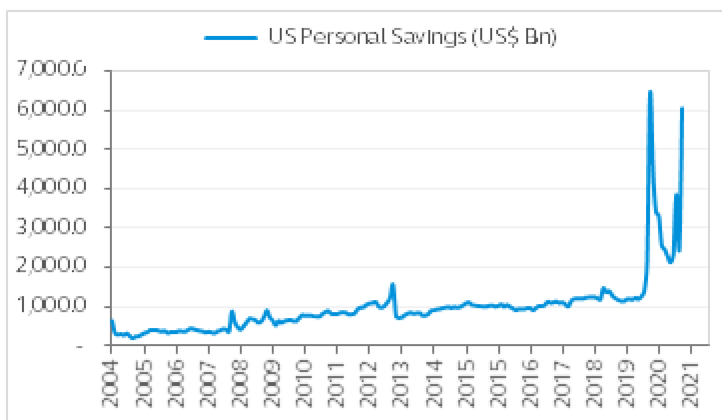


Exhibit LA2: Record US discretionary savings



Source: Bloomberg/Factset/Principal Global Asset Allocation, PGI Economic Committee. As of March 31, 2021.

2. Inflation

Our Leading Indicator continues to predict higher headline inflation till at least 3Q'2021, powered by higher commodity prices. While the US Fed has dismissed the inflation spike as unworthy of attention, it may start getting concerned if inflation expectations stay persistently above its goal (we think the de facto goal is 2.25% given the new inflation targeting framework which has built-in tolerance for a higher level of inflation to make up for past shortfalls).

10-yr CPI Swaps are pricing inflation @ 2.5% in US, 1.5% in Germany, 3.7% in UK and 2.2% in Australia, which won't bother policy makers much at this stage. However, if markets start pricing a structural shift, powered by a persistently loose monetary-fiscal setting and significant supply-side constraints (tight labor markets, restrictions on movement of labor and shortage of raw materials like semi-conductors and other critical components), inflation could get more embedded, drawing policy action. For EMs, higher oil and food prices remain a headwind as their inflation baskets are biased towards food and energy. While the current levels of realized inflation (EM CPI was 2.5% in Mar'2021) leave cushion to absorb higher prices, it cannot be denied that inflation risks are higher today for the group than in the past few years.

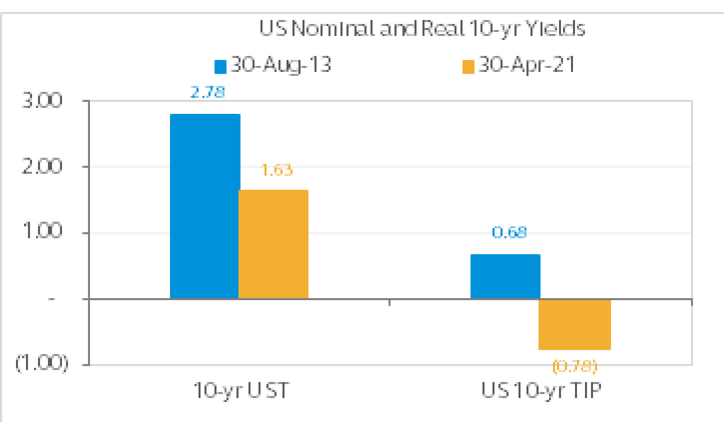
3. Monetary policy & global financial conditions

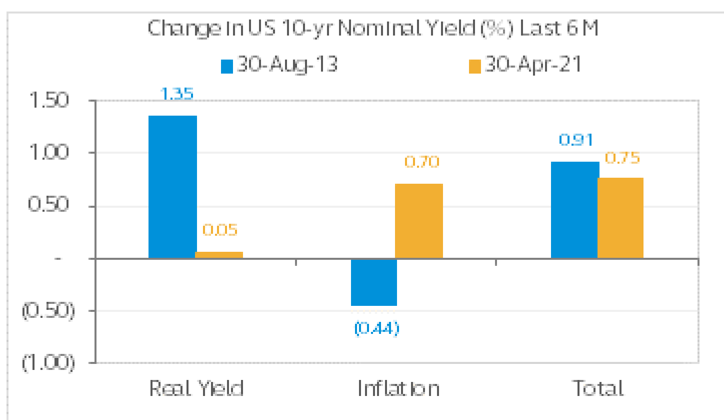
Global monetary policy remains extremely easy but the future path has become a little more uncertain, influenced by the visible growth divergence between US and other DM economies. The talk is increasingly about rate hikes in US and several EMs as implied by steeper yield curves. Market pricing shows US$ libor reaching 44bp (-6bps) by end 2022 and 106bps (-15bps) by 2023, though the Fed is still guiding for an unchanged rate (0.125%) through 2023. 1-month US treasuries (a good proxy of Fed funds rate) are expected to reach the long-run Fed funds rate of 2.5% in 2025. On the other side, ECB and BoJ will remain dovish for a prolonged period, given the much longer distance they must travel to get to inflation goals.

We expect G4 Central Bank balance sheets to rise by $4.1 trillion to US$ 28 trillion (63% of their GDP) in 2021. We also remain convinced that the Fed will shift its asset purchases to the longer end of the curve.

A natural question that comes to the fore is if the current rise in yields can push us **towards the taper-tantrum type market reaction of 2013**. We think the conditions today are different as shown in Exhibit LA2. Both nominal and real US yields are much lower today than in 2013. Back then, the real yield had jumped 135bps into restrictive territory, while inflation expectation had dropped -44bps, but this time around, the rise in real yield is negligible, with recovering inflation expectations explaining almost all of the rise in nominal yield. Also, EMs are better prepared this around, with stronger external accounts, higher FX reserves, and a positive gap of around 250bps between EM and US real yields versus almost 0% back in 2013.

Exhibit LA2: Taper tantrum of 2013 and current movement in yields





Source: Bloomberg/Factset/Principal Global Asset Allocation. As of April 30, 2021.

4. **Valuations**
   - **Anti-fragile assets** like global safe-haven US treasuries and gold are getting into a fair value zone. Ex-US DM treasuries remain expensive, particularly in Europe.
   - **Equity** valuations remain rich. While valuations should start normalizing as the recovery matures and as interest rates normalize further, equities should still deliver positive returns. Valuation normalization could be delayed if growth continues to surprise on the upside.
   - **Corporate spreads** are also in an expensive zone. With most spreads close to cycle lows, room for them to compress further is minimal.
   - In **Currencies,** the US$ is still on the expensive side. Growth and monetary policy divergence raise the bar for the US$ to weaken in the near term.

5. **Sentiments & technical indicators**
   Equity inflows suggest animal spirits are back. Retail participation in markets remains high. Overall risk positioning indicators remain extended but are sending mixed signals overall.

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 is a huge positive though new cases are resurging in some countries. Reopenings are rising in US but the picture is mixed elsewhere. Overall, this factor stays **"positive".**
   b. **Growth:** Both macro and bottom-up growth environments continue to improve. Buffer with savers and more US stimulus make us keep this factor as **"positive".**
   c. **Monetary policy** – Central banks may be forced to tighten policy at the margin. Financial conditions, though remain very easy, causing us to keep this factor as **"positive".**
   d. **Fiscal policy** – More US fiscal stimulus before the end of the year provides upside risks 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 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 we understand that valuation factors don't necessarily play out in the short-term, we are cognizant of their medium-term risks, which causes us to keep this factor at **"negative".**
   f. **Technical factors:** Technical signals gave us mixed messages in Apr'2021 though many of them remain stretched. We keep this factor as **"negative"** in the near term.

7. **Key risks**
   The key risks to our pro-risk allocation stance are-
   - A delayed reopening of the global economy caused by vaccine disappointments (either because people don't take it or because it isn't successful in restraining mutated strains of the virus). Countries like India are experiencing a new virus wave which will delay their growth recoveries.
   - Too much of a good thing i.e. short-term growth/inflation boost is misconstrued as structural, forcing central banks to adopt restrictive monetary policies, particularly in the US.
   - China's policy stance changes from supportive to restrictive, and they end up restraining large cap technology companies too much in pursuit of broader socialistic goals.
   - The US technology sector faces headwinds as regulators try to reign in large-cap technology companies.
   - Higher corporate taxes as OECD succeeds 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 for polls.

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

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