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Multi-Asset perspectives

Courtesy of Principal Global Investors

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May 2021

Market Summary

Macro

- **Global infections** rose **to 171 million** by end-May'2021 with 19m new cases during May'2021. The 7-day average of new cases eased from the prior month's high of 812k to 496m with India dropping from ~400k to ~200k. Most other countries saw declines too. **Global Fatalities** rose at a slightly slower pace than new cases, reaching **3.6 million**. The global mortality rate was steady at 2.1%. **Our Global Stringency Index** that uses Oxford data, improved to 61 from 66 (100=highest stringency) on increased re-openings in US, Europe, and China even as India, Japan, Malaysia, and Singapore imposed new restrictions. **Global vaccinations** gathered further momentum, with **760m new doses administered**. China's vaccination count ballooned to 660m, taking the global count to **1.9bn**. Relative to populations, UAE and Israel remained in the lead, administering 117 and 115 doses per 100 residents respectively. US reached 90 per 100, UK 97, Chile 96, and most European countries 60 each.
- **Economic recovery showed strength.** US fiscal spending continues to push US growth estimates higher. Our global Manufacturing PMI remained elevated at 57.5. Global industrial output grew strongly at 9.7yoy in Mar'2021 and our leading industrial production Indicator continues to predict strong readings ahead. Global Financial conditions remained easy. 1Q'2021 reporting season turned out to be strong and corporate earnings estimates ticked up further. Global Macro-economic surprises, however, turned negative, dragged by China.
- **Global inflation** rose to 2%yoy (3m average) in Apr'2021, with Apr'2021 reading (2.6%) higher than Mar'2021 (2%). **Our leading indicator continues to project higher reading 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 23% from 22%. 2021 was at 37% and 2022 at 10%.
- The ratio of **global credit rating upgrades to total changes** edged up to 53% from 51%, powered by US high yield.

Valuations

- **Equities** stayed expensive on earnings-based measures, though fading base effects made them cheaper as compared to Apr'2021. Low real rates, strong growth and continued policy support can sustain the richness.
- **IG and HY** spreads remained expensive.
- **US 10-yr treasuries:** Both our time-trend model and our fundamental fair value models peg US treasuries close to fair value after upward movement in yields over the last 12 months.

Markets

- **Multi-Assets:** Our global multi-asset index returned 1.3% in May'2021 to take YTD'2021 return to 5% (the last 12-month returns remained astronomical at 25% but will start rolling off as base effects fade).
- **Equities** ground higher, overcoming inflation concerns as central banks (particularly the US Fed) pushed back against an immediate policy response. Several positives i.e. progress in the pace of vaccinations, further growth recovery, fairly easy financial conditions, and continued inflows from investors also helped. 33/40 markets gained, with a median local currency return of 1.9% which took median YTD'21 return to 10.9% with 36 markets in the green. Europe, LatAM, EEMEA and Financials outperformed, while US, HK/China & Technology lagged.
- **Fixed income:** While policy rates were broadly unchanged, PGAA's Global Sovereign 10-yr yield indicator ended -3bps lower at **2.47%** as yields continued to consolidate after spiking in 1Q'2021. Credit spreads remained tight and near cycle lows. Bond returns were positive with favorable FX effects (US$ weakness) helping ex-US assets.
- **Currencies:** The US$ slid lower against both DM and EM currencies, driven by recovering ex-US growth which helped the Euro and pulled EMFX along with it. Other factors that played a role were further increases in global commodity prices which helped commodity currencies, a pushback by the Fed against policy recalibration in response to the inflation spike, a rising US trade deficit, and US$ rich valuations.
- **Commodities**: The GS commodity index was up 3%, with gains in all sectors barring agricultural commodities, which swelled YTD'2021 return to 27%. Speculative open interest remained elevated at $790bn.

Outlook

1. **Growth – outlooks still seeing upward revisions**

   The global economy continues its recovery from the COVID-19 related shock, aided by extremely supportive financial conditions, expansionary fiscal policy, and rising vaccinations. OECD raised its global growth forecast to 5.8% (5.6% earlier) for 2021 and 4.4% (4% earlier) for 2022, with upgrades in all major economic blocks. It acknowledged that while the global economy has returned to pre-pandemic activity levels, it has not yet achieved the growth expected prior to the global health crisis.

   While growth risks generally skewed to the upside, there exist some that could dent the recovery.

2. **Inflation**

   Our Leading Indicator continues to predict higher headline inflation till at least 3Q'2021. While the US Fed continues to treat the recent inflation spike as largely transitory, it will start getting concerned if inflation expectations stay persistently above its goal (we think the de facto goal is 2.25% under the new inflation targeting framework). We also think the Fed may move to a 2-yr annualized measure of inflation to adjust for the volatility caused by base effects. On this count, the annualized 2-yr inflation for different segments of the US economy and other leading economies at the end of April were-

   Exhibit LA1: 2-yr annualized inflation at the end of April'2021

Measure	2-yr Ann rate	Measure	2-yr Ann rate
US PCE	2.0%	China CPI	2.1%
US Core PCE	2.0%	India CPI	5.7%
UK CPI	1.1%	Brazil CPI	4.6%
Germany CPI	1.4%	Mexico CPI	4.1%
Developed Economies	1.4%	Emerging Economies	3.1%

   Source: Bloomberg/Factset/Principal Global Asset Allocation. As of 4/30/2021.

   A key risk on the inflation discussion is if we start moving towards a structurally higher inflation trajectory, 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). While the risk exists, we think the probability of such a shift is still fairly low.

3. **Monetary policy & global financial conditions**

   G4 central bank balance sheets are likely to rise by **$3.9 trillion to US$ 28 trillion (62% of GDP)** versus **$8.4 trillion in 2020**. The global monetary policy remains extremely easy, but the future path is uncertain as different economies are at different stages of their growth/inflation cycles. US and EM yield curves are steeper, anticipating a faster pace of normalization than Europe and Japan, where curves are flatter as they remain far from meeting their inflation goals. Market pricing shows US$ 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.

4. **Valuations**
    - **Anti-fragile assets** like global safe-haven US treasuries and gold are nearer fair value zone than they were a year back. Ex-US DM treasuries remain expensive, particularly in Europe.
    - **Equity** valuations remain rich though base effects will make them less expensive in coming months. An environment of negative real yields and recovering growth should help generating positive returns from equities for some more time, despite the impending valuation normalization. On the other hand, the normalization itself could be delayed if growth remains strong for a prolonged period.
    - **Corporate spreads** are also tight. With spreads close to cycle lows, room for them to compress further is minimal.
    - In **Currencies,** the US$ is less expensive after another month of weakness.

5. **Sentiments & technical indicators**
    Equity inflows remained strong. Retail participation increased towards the end of May with investors seemingly moving away from cryptocurrencies back into US small caps. Overall risk positioning indicators remain extended.

6. **Summarizing our thoughts on risk assets:** We retain a pro-risk stance in our asset allocation framework while being conscious of compressed risk premiums. Our checklist of various factors stacks up as under-
    a. **Return-to-Work strategies:** Rising vaccinations remain a huge positive and new cases peaked in countries like India. Reopenings rose in the US, Europe, and China though but picture remained mixed in EMs. Overall, this factor stays **"positive".**
    b. **Growth:** Both macro and bottom-up growth environments remained strong. The existing savings buffers with US consumers (fiscal transfers) and potentially more US stimulus allow us to keep this factor as **"positive".**
    c. **Monetary policy** – Central banks are beginning to think of policy rate normalization though the pace remains very measured. Financial conditions remain very easy, causing us to keep this factor as **"positive".**
    d. **Fiscal policy** – An expansionary budget and further US fiscal stimulus provide upside risks to growth. Overall, we rate this factor as **"positive"** though higher taxes could create clouds of worries as the US political system looks for ways to fund the massive spending plans laid out by the President.
    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 their medium-term effects, which causes us to keep this factor at **"negative".**
    f. **Technical factors:** Technical signals remain extended. We keep this factor as **"negative"** in the near term.

7. **Key risks**
    The key risks to our pro-risk allocation stance are-
    - Vaccine disappointments (slow pace of acceptance or failure to control new variants of the virus could present the biggest challenge to risk assets).
    - Central banks react prematurely to higher cyclical readings of inflation and tighten policy prematurely.
    - Central banks start getting worried about asset bubbles. Housing prices, which are zooming in most parts of the world could start attracting attention.
    - China starts tightening policy to control the commodity price boom, triggered by excessive speculation in an environment of tight supplies and plentiful fiscal spending.
    - 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 (a minimum global corporate tax rate of 15% is being floated) including a global digital tax.
    - US-China relationship takes a turn for the worse.
    - European elections could throw a curve ball Germany (Sep'2021) and France (2022) head for polls.

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

Risk considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed.

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