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Multi-Asset perspectives

Courtesy of Principal Global Investors

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July 2021

Market Summary

Macro

- **Global infections** rose **to 198 million** by end-July'2021 with 15.6m new cases during July'2021. The 7-day average of new cases rose from the prior month's 373k to 585k as the delta strain spread across continents. **Global Fatalities** rose at a lower pace than new cases, reaching **4.2 million**. The global mortality rate eased to 2.1%. **Our Global Stringency Index** that uses Oxford data, improved slightly to 60 (100=highest stringency) mainly driven by easing restrictions in North America and UK while restrictions tightened in China and France. **Global vaccinations count** increased to 4.1bn, with **1044m new doses administered**, slightly lower than last month's 1148m. Relative to populations, UAE remained in the lead, administering 152 doses per 100 residents, followed by Singapore (132 per 100), Chile (131), Canada (129) and UK (127). US reached 105 per 100 with a significant slowdown in the vaccination pace, lagging behind most of European peers (110-120).
- **Economic recovery remained strong.** The economic impact of Delta variant spread is yet to be seen but it could delay monetary policy normalization and even prompt some additional fiscal stimulus. Our provisional global Manufacturing PMI eased but was still elevated at 56.4. Helped by a strong base effect, global industrial output grew 16.9 yoy in May'2021, and our leading industrial production Indicator continues to predict strong readings ahead. Global Financial conditions tightened slightly as easing from lower rates wasn't enough to offset the tightening from wider spreads and higher volatility. Global Macro-economic surprises were slightly negative as beats in China surprises were overshadowed by misses in other countries.
- **Global inflation** was flat at 2.9%yoy in June'2021. **Our leading indicator continues to project higher readings through 3Q'2021 before tapering down.**
- **Our cross-asset volatility indicator** finishd almost unchanged, staying below its long-term average. An intra-month spike caused by the spreading delta strain and China's crackdown on its education sector didn't sustain. Low volatilities generally support conditions for risk-taking.

Bottom-up

- MSCI AC World's **expected EPS** CAGR for 2021-22 rose to 24%. 2021 was at 43% and 2022 at 8%.
- MSCI AC World's **3m EPS change** eased to 5% in July'2021 from 6% in June'2021. The **3m Earnings Revisions Ratio** edged up to 0.62 from 0.61.
- The ratio of **global credit rating upgrades to total changes** edged up to 58% from 56%, powered by Western Europe IG (64%).

Valuations

- **Equities** valuations eased a tad on improving base effects but remained expensive. Latam and Southeast Asian markets were relatively cheap within EMs while Japan was the only non-expensive market in DMs. Low real rates, strong growth and continued policy support can sustain the richness.
- **IG and HY** spreads remained expensive.
  US 10-yr treasury yields declined, pushing them towards the expensive side in both our time-trend and fundamental fair value models. However, they are far less expensive than they were 12 months ago.

Markets

- **Multi-Assets:** Our global multi-asset index returned 0.9% in July'2021 to take YTD'2021 return to 6.7% (the last 12-month returns eased to 18% on fading base effects). Other than global high yield, all other asset classes delivered positive returns.
- **Equities** grounded higher, driven by US and Europe. 24/40 markets gained, with a median local currency return of 0.4%. Strong economic activity, continued policy support, decent earnings and floating liqduity remained tailwinds for equities. China's tech/education sector crackdowns triggered a mini market rout in Chinese stocks, which dented Asia/EMs in both absolute and relative returns.
- **Fixed income:** While policy rates were broadly unchanged, PGAA's Global Sovereign 10-yr yield indicator ended -16bps lower at **2.18%** as yields slid further on worries linked to the delta virus and a potential roll-off in inflation in coming months. Credit spreads for both investment grade and high yield widened a tad, but remained tight and near cycle lows.
- **Currencies:** The US$ was flat against broad trade weighted currencies. JPY and GBP advanced against USD while EM FX extended weakness on souring sentiment towards Chinese stocks.
- **Commodities:** The GS commodity index was up 1%, pushing YTD gains to 32%. All sectors barring agricultural commodities gained. The last twelve month return increased to 62%, helped by base effects.

Outlook

1. **Growth – strong but likely moderation ahead**
   The global economy continues its strong recovery, aided by supportive financial conditions, expansionary fiscal policy, and rising vaccinations. The spreading Delta variant, however, is causing concerns about return-to-work strategies in the US, where several companies seem to have slowed down planned returns to work-from-office. A spread of the virus could also dent China's growth, as it reinstitutes localized lockdowns. Several other EMs like Indonesia continue to struggle. On the positive side, India's new cases seem to have peaked, causing its PMIs to normalize higher. European growth remains strong and the spike in cases seems to be peaking, particularly in the UK.

2. **Inflation**
   Inflation remains a key area of focus for us, with our downside growth scenario envisioning a rapid response to higher inflation, which ultimately brings the recession forward. Our Leading Indicator continues to predict higher headline inflation till at least 3Q'2021 due to a combinaton of base effects and idiosyncratic factors like shortage induced price gains. Central banks, while recognizing inflation readings above policy targets, have so far tended to tide over them, terming them as transitory, which aligns with our view too. However, there is a risk that at least some of the inflation surge becomes more structural.

3. **Monetary policy & global financial conditions**
   Global monetary policy remains extremely easy, but the future path is potentially tighter as Central Banks recalibrate to address growth/inflation trajectories. EMs like Brazil, Russia and Mexico are already in the middle of hike cycles in response to higher inflation. In contrast, the US Federal Reserve is still on a hold mode on rates, but is considering tapering its asset purchase program. The spreading delta variant could, however, tie its hands despite inflation staying above its policy target for at least a few more months. ECB's new inflaton framework gives it tremendous flexibility, with the bar for them to tighten rather high. Bank of Japan is nowhere near its inflation goal either. Overall, while we ultimately expect higher policy rates and yields going ahead, the pace of normalization will primarily be determined by developments on the delta virus.

4. **Valuations**
   - **Global risk premiums remain low.** Risk-free rates too remain suppressed.
   - **Equity** valuations remain rich though base effects will make them less expensive in coming months as we leave behind weak 2020 EPS numbers. An environment of deeply negative real yields and recovering growth should help generate positive returns from equities for some more time despite rich valuations.
   - **Corporate spreads** remain tight and the room for them to compress further is minimal.
   - In **Currencies,** the US$ remains a tad expensive.

5. **Sentiments & technical indicators**
   Equity inflows remained strong and retail participation high. Price momentum too remains strong though market breadth has weakend in recent weeks, with Value strategies and EMs failing to keep pace with US equities. Overall, risk positioning indicators remain a little extended though less so than the last month.

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 though rising delta variant cases are acting as a dampener, testing vaccine efficacies. We still feel that we are headed in the right direction, while keeping a close eye on developments on this front. We retain the factor as **"mildly positive".**
   b. **Growth:** Both macro and bottom-up growth environments remained strong though the end of summer holiday spending could cause consumers to pull back somewhat in coming months amidst rising cases. Consumers still retain savings buffers and there exists the potential for more US fiscal stimulus, allowing us to keep this factor as **"positive".**
   c. **Monetary policy** – Central banks are moving towards policy rate normalization, with EMs leading DMs. However, global financial conditions remain very easy, causing us to keep this factor as **"positive".**
   d. **Fiscal policy** –US stimulus is likely to rise through additional infrastructure spending, though a large package will come with higher taxes. Overall, we still keep this factor as **"mildly positive"**.
   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 financial conditions remain easy, real rates deeply negative and forward-looking growth outlook strong. Valuation factors don't necessarily play out in the short-term but we remain cognizant of their medium-term effects, which causes us to keep this factor at **"negative".**
   f. **Technical factors:** Technical signals remain extended though less so than in recent months. We rate this factor as **"mildly negative".**

7. **Key risks**
   The key risks to our pro-risk allocation stance are-
   - Vaccine disappointments amidst rising delta variant cases.
   - Persistent inflation causes Central banks to tighten policy prematurely, particularly the US where the Fed has arguably closer to achieving its inflation goal while lagging its employment one.
   - Central banks get worried about asset bubbles. Housing prices, which are zooming in most parts of the world could start attracting attention soon.
   - Chinese actions against the technology sector intensifies capital flight from one of the best performing themes of recent years.
   - Higher corporate taxes: while OECD's success in implementing a minimum global corporate tax rate of 15% is welcome and shouldn't cause any ripples in the market place, if there are large increases in standard corporate tax rates to fund fiscal spending programs, it will dent corporate earnings.
   - US-China relationship takes a turn for the worse.
   - European elections throw a curve ball Germany (Sep'2021) and France (2022) head for polls.

Risk considerations

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