Multi-Asset perspectives

Courtesy of Principal Global Investors

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June 2021

Market Summary

Macro

- **Global infections** rose **to 182 million** by end-June'2021 with 11.6m new cases during June'2021. The 7-day average of new cases eased further from the prior month's 496k to 373k. However, cases started to speed up in Europe with more infectious delta strain taking hold. **Global Fatalities** rose at a slightly higher pace than new cases, reaching **3.9 million**. The global mortality rate edged up to 2.2%. **Our Global Stringency Index** that uses Oxford data, improved slightly to 59 from 61 (100=highest stringency) as most countries kept restrictions unchanged. **Global vaccinations** gathered further momentum, with **1148m new doses administered**. China's vaccination count ballooned to 1.2bn, taking the global count to **3.1bn**. Relative to populations, UAE remained in the lead, administering 141 doses per 100 residents. Chile surpassed Israel with 119 does per 100 residents versus Israel's 118. US reached 100 per 100, UK 118, Canada 104, and most European countries around 90.
- **Economic recovery strength continued.** After two months of weakness, US jobs report finally beats expectations as hiring picked up in services. Our global Manufacturing PMI was lower a tad from last month but remained elevated at 57.1. Helped by a strong base effect, global industrial output grew at 24.8 yoy in Apr'2021, with our leading industrial production Indicator continuing to predict strong readings ahead. Global Financial conditions tightened as monetary growth normalized lower, but rates, spread and volatility components remained easy. Global Macro-economic surprises were flat as positive European surprises were nullified by misses in Japan.
- **June FOMC meeting surprised markets on the hawkish side.** Expectations of tapering and rates hike were moved forward by Fed's optimistic outlook on employment recovery. A hawkish dot plot implies two rate hikes in 2023. The markets are moving to a sooner lift of in federal funds rate but a shallower rate hike cycle (flatter yield curve).
- **Global inflation** rose to 2.8%yoy in May'2021, fueled by base ef ect, supply chain disruptions and global commodity prices rally. **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 remained at 23%. 2021 was at 38% and 2022 at 10%.
- MSCI AC World's **3m EPS change** improved to 7% in June'2021 from 6% in May'2021. The **3m Earnings Revisions Ratio** rose to 0.61 from 0.60.
- The ratio of **global credit rating upgrades to total changes** edged up to 56% from 53%, powered by US HY (64%).

Valuations

- **Equities** valuation remained expensive. Of all the markets we tracked, only Eastern Europe, Latam and Southeast Asia are not flagging expensiveness. Low real rates, strong growth and continued policy support can sustain the richness.
- **IG and HY** spreads remained expensive.
- **US 10-yr treasuries:** After recent rally, treasury yield is leaning towards expensive side in our time-trend model and fundamental fair value model. However, they are closer to fair value compared to 12 months ago.

Markets

- **Multi-Assets:** Our global multi-asset index returned 0.7% in June'2021 to take YTD'2021 return to 5.8% (the last 12-month returns remained astronomical at 22.4% but will start rolling of as base ef ects fade).
- **Equities** ground higher, driven by US growth rebound as yields edged lower. Solid economic activity recovery, fast vaccination progress in many countries, easy financial conditions, strong earnings revision momentum and floating liqduity helped equities. Returns are less broad based compared to last month. 22/40 markets gained, with a median local currency return of 0.6%.
- **Fixed income:** While policy rates were broadly unchanged, PGAA's Global Sovereign 10-yr yield indicator ended -6bps lower at **2.34%** as yields continued to consolidate after spiking in 1Q'2021. Credit spreads remained tight and near cycle lows. High yield spread narrowed further.
- **Currencies:** The US$ advanced against both DM and EM currencies, driven by Fed's hawkish turn.
- **Commodities**: The GS commodity index was up 4%, driven soley by energy, pushing last 12 monthh returns to 57.4%.

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. Over the last quarter, while we saw an acceleration in manufacturing and service activity for regions with high vaccination rates (like the US, UK, Europe), parts of the world with less successful vaccination programs suf ered from periodic infection resurgences and weaker economic expansion. Manufacturing PMIs for emerging markets disappointed, as these regions were unable to take advantage of increased demand from developed markets. However, if vaccinations broaden by early 2022, emerging markets will experience the same growth dynamics that developed markets are experiencing now. Economic growth will be extraordinary in Q2'2021 for developed markets with high vaccinations, but growth is unlikely to accelerate further. As vaccinations increase in emerging markets, they will take the baton in leading global growth.

   In their June'2021 projections, PGI's Economic Committee upgraded its global growth forecasts as compared to its projections made in Mar'2021, with a lage bump in 2Q'2021 GDP for the US. We also expect GDP to rise 7% 4Q'201/4Q'2020 and 2.4% 4Q'2022/4Q'2021. Our outlook for Europe too strengthened, powered by rising vaccinations, continued positive economic surprises and a boost from spending under the EU Recovery Fund. Our team, though is a little more sanguine on Chinese growth as compared to consensus, with policy shifting to balanced from supportive. China's continued crackdown on its large-cap technology companies also add to growth headwinds at the margin.

2. **Inflation**

   Our Leading Indicator continues to predict higher headline inflation till at least 3Q'2021 due to a combinaton of base ef ects and continued strength in commodity prices. We think Central banks will likely ignore inf ation distortions from base ef ects, temporary supply chain constraints, and temporary reopening demand surges. The only caveat is if these transitory forces turn sticky by unanchoring inflation expectations, or if demand-side pressures start building up sustainably. In fact, inflatin 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.

3. **Monetary policy & global f nancial conditions**

   The global monetary policy remains extremely easy, but the future path is likely higher as Central Banks recalibrate policies to address local growth/inflation trajectories. EMs are clearly ahead of DMs in normalizing policy rates higher, led by Latin America where Brazil and Mexico have started policy hike cycles in response to higher inflation. Russia is in the same boat, which most Asian Central banks are still in a wait-n-watch mode. In contrast, the US Federal Reserve and European Central Bank may be more patient, as US and Europe had problems with inflation undershoots not overshoots in the last decade. Central banks with a dual mandate of price stability and maximum employment, like the Fed, are likely to react stronger to demand-side inflation because it is persistent, self-sustaining, and usually coupled with a strong labor market. While a supply-side shock would increase inflation, it also hurts economic output, so raising rates would violate the second half of the dual mandate for full employment. We continue to closely monitor inflation expectations which may shift monetary policy.

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 EPS numbers from 2020). An environment of negative real yields and recovering growth should help generating positive returns from equities for some more time, despite rich valuations.
    - **Corporate spreads** are also tight. With spreads at cycle lows in most regions, 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. Retail participation remains high. Price momentum remains strong, particularly for US equities. 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. While the delta variant is posing some questions in some countries, the overall direction is in the right direction. Overall, this factor stays **"positive".**
    b. **Growth:** Both macro and bottom-up growth environments remained strong. The existing savings buf ers with global consumers (fiscal transfers) and potentially more US stimulus allow us to keep this factor as **"positive".**
    c. **Monetary policy** – Central banks are moving towards policy rate normalization, with EMs leading DMs. Global Financial conditions remain very easy, causing us to keep this factor as **"positive".**
    d. **Fiscal policy** – The EU recovery fund and potentially more US 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.
    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 ef ects, which causes us to keep this factor at **"negative".**
    f. **Technical factors:** Technical signals remain extended. We keep this factor as **"negative".**

7. **Key risks**
    The key risks to our pro-risk allocation stance are-
    - Vaccine disappointments (complacency or failure to control new variants of the virus).
    - Persistent inflation causes Central banks to tighten policy prematurely.
    - Central banks start getting worried about asset bubbles. Housing prices, which are zooming in most parts of the world are likely to start attracting attention soon.
    - Large cap technology sector comes under pressure - China institutes even deeper curbs on its technology sector than it has in recent months, while US Congress passes laws to restrain the power of large-cap tech.
    - 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, that 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

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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