Multi-Asset perspectives

Courtesy of Principal Global Investors

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August 2021

Market Summary

Macro

- **Global infections** rose **to 218 million** by end-August'2021 with 19.9m new cases during the month. The 7-day average of new cases rose from the prior month's 585k to 648k as the delta strain continued to spread, infecting even vaccinated persons, which raised the prospects of adoption of booster shots. Having said that, it is without doubt that vaccinated persons faced a much lower hospitalization rate than unvaccinated ones. **Global Fatalities** rose at a slower pace than new cases globally, reaching **4.5 million** (mortality rate of 2.1%) though trends in some countries was worrisome. **Our Global Stringency Index** that uses Oxford data, increased slightly to 63 (100=highest stringency) indicating that the pace of reopening stalled.
- A positive from the rising delta variant infections was a pick-up in the pace of vaccinations, with the global count increasing by 1.21bn doses to 5.3bn, about 15% higher than previous month's pace of 1.05bn. Relative to populations, UAE remained in the lead, administering 165 doses per 100 residents, followed by Singapore (154 per 100), Israel(150), Chile (149) and China (147). US (112) continued to lag European peers (120-140).
- **Economic recovery remained strong and uneven.** Our provisional global Manufacturing PMI eased from last month but was still elevated at 55.9. while the Global industrial output growth slowed to 10.8% yoy in June'2021 from 17% on fading base effects, our global industrial production leading indicator still suggests above trend growth in coming months. Global Financial conditions remained largely unchanged and very accommodative, with tighter spreads compensating for slightly higher interest rates during the month. Global Macro-economic surprises were negative for a fourth consecutive month (Japan was the only one to clock a positive surprise), suggesting a raised growth bar.
- **Global inflation** continued its ascent, reaching 3.1%yoy in July'2021. **Our leading indicator projects higher reading through 3Q'2021 before tapering down.** The US **Fed** continued to view transitory factors as the main contributor to high inflation, much like our own economics team.
- **Our cross-asset volatility indicator** remained below its long-term average as equity volatility declined further. Low asset volatility generally supports risk-taking.

Bottom-up

- MSCI AC World's **expected EPS** CAGR for 2021-22 nudged higher to 25%. 2021 was at 45% and 2022 at 7%.
- MSCI AC World's **3m EPS change** dropped to 4% in August'2021 from 5% in July'2021. The **3m Earnings Revisions Ratio** eased to 0.61 from 0.62.
- The ratio of **global credit rating upgrades to total changes** were unchanged at 58%.

Valuations

- **Equity** valuations eased as earnings continued to improve, but they remain expensive, but low real rates, strong earnings growth and continued policy support can sustain the richness. Only Japan wasn't flagging expensiveness among major developed markets. Within emerging markets, Latam and Southeast Asia were relatively cheap.
- **IG and HY** spreads remained expensive.
- **US 10-yr treasury** yield increased by 9bps, still leaning towards expensive side in our time-trend model and fundamental fair value model.

Markets

- **Multi-Assets:** Our global multi-asset index returned 0.9% in August'2021 to take YTD'2021 return to 7.7%. Gains from global equities, EM debt and global HY outweighed losses in high grade fixed income and commodities.
- **Equities** rallied by 2.5%, led by US. The rally was broad based with 34/40 markets gaining. Strong economic activity and earnings growth, continued policy support, and significant liquidity provided tailwinds to overcome concerns linked to the delta variant, and a relative monetary policy tightening that is bound to happen in coming months.
- **Fixed income:** PGAA's Global policy rate indicator increased to 1.16% as several EM central banks raised rates. PGAA's Global Sovereign 10-yr yield indicator ended 5bps higher at **2.2%**. High yield spreads narrowed a tad while investment grade spreads were mostly unchanged. Both remained near cycle lows.
- **Currencies:** The US$ appreciated by 0.6% against a broad trade-weighted currency basket. Sustained US$ appreciation could present a challenge for risk assets.
- **Commodities:** The GS commodity index was down -2.5%, reducing YTD gains to 29%. Energy sector was the main contributor, as markets baked in lower near-term oil demand due to the delta variant impact.

Outlook

1. **Growth – strong but an expected moderation ahead**
   The global economy continues to recover, aided by extremely supportive financial conditions, expansionary fiscal policy, rising vaccinations and strong earnings growth. While the spreading delta variant is a concern, a significantly lower incidence of serious cases among those who get infected despite vaccination is mitigating its impact. While reopenings have stalled, particulary in the US where several companies have pushed return to work-from-office by 1-3 months, the path ahead is getting clearer – one that involves near-compulsory vaccinations (vaccine passports), booster shots (Israel has already started administering them), delayed herd immunity, and flexibility in choosing work from home relative to being in office.

   Risks from the delta variant remain significant as evidenced by an immediate decline in economic activity in countries that were forced to implement lockdowns (Australia and China were prime examples of that in recent weeks). Several EMs remain challenged, which continues to impact supply chains adversely (automobile companies in particular are reeling from such disruptions), hitting growth. It has increased the downside risks to growth and left little room for upside surprises. However, our base case remains well anchored at above trend growth in DMs for both 2021 and 2022. EMs should take over the growth mantle sometime in 2022 as rising vaccinations push them towards herd immunity.

   Another risk to growth emanates from continued regulatory tightening in China, which is causing ripples in its massively successful technology sector. The reset involves a more level playing field for smaller players, data protection measures and most importantly, a de-facto obligation on the part of the tech giants to give back to the society. Unsurpisingly, one Chinese tech giant after another announced sizeable social spending plans to send the right signals to Chinese leadership. It remains to be seen if the regulatory squeeze has run its course or has more legs.

2. **Inflation**
   Inflation remains a key area of focus, with our downside growth scenario envisioning a rapid monetary response to higher inflation which hastens a recession. While our leading Indicator continues to predict higher headline inflation for a couple more months, followed by a noticeable roll-off thereafter. However, there is a risk that at least some of the inflation surge becomes more structural. Policy action has so far been divergent, with DM and Asian central banks in the camp that believes spiking inflation is transitory, where as Latin American central banks (Brazil, Mexico and Chile) have proactively tightened policy settings to nip rising inflation. We remain cognizant of risks emanating from persistently high inflation prints.

3. **Monetary policy & global financial conditions**
   Global monetary policy remains extremely easy, but the path ahread will see calibrated withdrawal of accommodation. EMs like Brazil, Mexico and Russia took the lead in rasing policy rates, while Chile (a very hawkish stance of late) and Korea joined the bandwagon last month. On the other hand, the US Fed is trying to implement a dovish tightening, likely to start with a gradual tapering of its asset purchases sometime in 4Q'2021. Bank of Canada has already reduced its pace of asset purchases, while the BoE could follow suit. However, ECB remains dovish despite alarm bells being rung by the Bundesbank on inflation. Overall, while we do expect higher policy rates and yields going, the pace of normalization will be measured and is unlikely to cause financial conditions to tighten dramatically.

4. **Valuations**
   - **Global risk premiums remain low.** Risk-free rates also remain suppressed.
   - **Equity** valuations remain rich though base effects will reduce their expensiveness 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 on the expensive side.

5. **Sentiments & technical indicators**
   Equity inflows remained strong and retail participation high. Price momentum too remains strong alongside market breadth. 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:** Accelerating vaccinations remain a huge positive though increasing incidence of infection among the vaccinated is delaying herd immunity and reopening timelines. While we feel that we are headed in the right direction, we downgrade this factor a notch to **"neutral" from "mildly positive".**
   b. **Growth:** Both macro and bottom-up growth environments remain strong though the second order derivative (rate of change) is weakening, which is not entirely unexpected. Consumers still retain savings buffers and there exists a potential for more US fiscal stimulus, allowing us to keep this factor as **"positive". However, risks from the delta variant, inflation and Chinese regulatory tightening cannot be ignored.**
   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 retain this factor at **"positive".**
   d. **Fiscal policy** –US stimulus is likely to rise through additional infrastructure spending, though a large package will likely 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. 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 in the US where the only thing preventing it from running a tigher monetary policy is the fact that it lags its employment goal.
   - Central banks get worried about social implications of asset bubbles including housing prices, which have been running hot in most parts of the world.
   - China's attempt to reset its relationship with the successful technology sector intensifies capital flight with adverse contagion effects on other emerging markets.
   - Higher corporate taxes: Large increases in standard corporate or personal tax rates to fund fiscal spending programs are a risk to markets.
   - US-China relationship takes a turn for the worse.
   - European elections throw a curve ball as Germany (Sep'2021) faces real prospect of an unclear manate to either of the two large blocks – the ruling CDU/CSU combine and the SPD/Green block.

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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