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Multi-Asset perspectives

Courtesy of Principal Global Investors

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September 2021

Market Summary

Macro

- **Global infections** rose **to 234 million** at the end of September'2021 with 16m new cases during the month. The 7-day average of new cases dropped from prior month's 646k to 450k as the delta curve peaked in several countries. **Global Fatalities** rose at a slower pace than new cases, reaching **4.8 million** (mortality rate of 2.0%) though trends in some countries remained worrisome. **Our Global Stringency Index** that uses Oxford data, was stable at 63 (100=highest stringency) but US stringency increased from 56 to 62 as plans to return to work were delayed.
- **Global vaccination count** increased by 963mn doses to 6.3bn, with the pace slower than previous month's 1.2bn. Part of the reason was a natural slowdown in countries which have vaccinated a large part of their population. UAE remained in the lead in vaccinating its people, with 182 doses per 100 residents, followed by Chile (167 per 100), Israel (166), Singapore (163) and China (158). US (120) continued to lag European peers and Japan (130-150).
- **Economic activity remained strong, but momentum slowed.** Our provisional global Manufacturing PMI was stable at 55.9. While Global industrial output growth slowed to 7.2% yoy in July'2021 from 10.9% during the month prior on fading base effects, our leading indicator continues to suggest above-trend growth in coming months. Global financial conditions tightened a tad from the very accommodative levels, driven by wider credit spreads and higher volatility. Global Macro-economic surprises were negative for a fifth consecutive month, suggesting that the bar is already high for surprises to be positive.
- **Global inflation** continued its ascent, reaching 3.2%yoy in August'2021. **Our leading indicator projects higher readings through at least 3Q'2021 before tapering down by the end of the year. However, that could come under question if commodity prices continue to zip higher.** While our economists and the US **Fed** believe transitory forces to be behind a bulk of recent inflation surge, prolonged supply bottlenecks and shortages present significant risks.
- **Our cross-asset volatility indicator** had a marked bounce this month towards their long-term median, triggered by inflation concerns, the impending monetary policy tightening in the US, and defaults by the large Chinese property developer, Evergrande. Equity volatility jumped to its highest since March'2021.

Bottom-up

- MSCI AC World's **expected EPS** CAGR for 2021-22 was almost flat at 24%, with 2021 at 44% and 2022 at 8%.
- MSCI AC World's **3m EPS change** dropped to 3% in September'2021 from 4% in August'2021. The **3m Earnings Revisions Ratio** eased to 0.60 from 0.61, suggesting easing momentum.
- The ratio of **global credit rating upgrades to total changes** improved further to 59%.

Valuations

- **Equity** valuations eased as markets corrected, but they remained expensive, led by the US. Within emerging markets, Latam and Southeast Asia were relatively cheap.
- **IG and HY** spreads remained expensive.
- **US 10-yr treasury** yield increased by 18bps but was still leaning towards expensive in both our fundamental fair value and time-trend models. However, the expensiveness reduced.

Markets

- **Multi-Assets:** Our global multi-asset index lost -2.4% in September'2021 to shrink YTD'2021 return to 5.1%. Other than commodities, all assets delivered negative returns.

- **Equities** dropped by -4.1%. The loss was broad based with 29/40 markets ending in the red. Concerns on China's slowdown, a hawkish Fed, failure on the part of the US Congress to expand the debt ceiling, and energy shortages which reinforced inflationary concerns were factors that explained the correction.

- **Fixed income:** PGAA's Global policy rate indicator increased to 1.18% with 7 hikes and 1 cut during the month. PGAA's Global Sovereign 10-yr yield indicator ended 12bps higher at **2.32%**. High yield and investment grade spreads were mostly unchanged and remained near cycle lows, barring Asia where the Evergrande default widened HY spreads significantly.

- **Currencies:** The US$ appreciated by 0.4% against a broad trade-weighted currency basket. Sustained US$ appreciation presents a challenge for risk assets.

- **Commodities:** The GS commodity index was up 6.0%. Higher energy prices were the main contributor to the rally, as negative supply shocks, tight inventories, and resilient demand fueled furthered the oil price rally. OPEC didn't show any inclination to raise output above its pre-committed levels.

Outlook

1. **Growth – strong but expect moderation ahead**
   The global economy continues to grow, aided by supportive financial conditions, accumulated dry powder in the hands of global consumers from fiscal handouts, and rising vaccinations. Infections from the delta variant seem to have peaked. The variant wasn't as severe on vaccinated people either, which implied a postponement rather than curtailment of some economic activity. A big positive to take from developments in recent months is the pace at which EMs are vaccinating. In the last 2 months, global vaccinations totaled 2.1bn of which 1.2bn were in the larger EMs and 715m in smaller EMs. China (520m), India (420m) and Brazil (97m) implemented strong vaccination drives, which bodes well for both global growth and supply-chain dynamics. However, growth faces two key risks: a) the default by Evergrande is bound to impact growth adversely in China as regulators work out a deal to settle its large pile of debt obligations, and b) the continued strength in inflation driven by higher oil and gas prices which acts as a tax on consumers could slow them down.

   While our base case remains anchored to above-trend growth in DMs for both 2021 and 2022, the risks have tilted somewhat to the downside in the last few weeks. Recovering EMs, however, could make up for the shortfall, though their outlook too is getting clouded by tightening financial conditions (Latin America and EEMEA is tightening policy at rapid speed though Asian central banks have generally stayed put), brought about by rising inflation.

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 the next two months, it also predicts a roll-off by the end of the year. However, there is a risk that the expected roll-off gets delayed by the continued strength in commodity prices. There is also the risk that some of the inflation surge becomes more structural.

3. **Monetary policy & global financial conditions**
   Global monetary policy remains easy, but the path ahead will see calibrated withdrawal of accommodation. EMs have already taken the lead in this respect, with the US Fed likely to follow suit in gradual steps starting in 4Q'2021. It will start with a tapering of its asset purchases, which will culminate in rate hikes starting either late in 2022 or early in 2023. While we do expect higher policy rates and yields going forward, the pace of normalization is likely to be measured, which should prevent financial conditions from tightening dramatically.

4. **Valuations**
    - **Global risk premiums remain low.** Risk-free rates also remain suppressed.
    - **Equity** valuations remain rich though base effects and the recent correction have reduced their expensiveness. 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. However, price momentum has weakened, and volatilities have picked up. Overall, the risk positioning indicators have turned neutral from overbought.

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 reopenings have stalled. While we feel that we are headed in the right direction, we retain this factor at **"neutral".**
    b. **Growth:** Both macro and bottom-up growth environments remain strong, though the second order derivative (rate of change) is weakening, as expected. 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 higher inflation, weaker housing affordability, and tighter financial conditions cannot be ignored.**
    c. **Monetary policy** – Central banks are moving towards policy 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 though the size of infrastructure package is still uncertain. Besides, some of the spending will be met by higher taxes. In the Euro Area, however, spending from the Recovery fund will provide a fiscal boost. China, after months of tightening, might feel encouraged to add some stimulus to the economy to ease the headwinds to growth from the power crisis and the Evergrande fallout. Overall, we 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, and forward-looking growth outlook positive. 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 were mixed last month, which makes us reduce them to "**neutral**" from **"mildly negative".**

7. **Key risks**
    The key risks to our pro-risk allocation stance are-
    - Vaccine disappointments as new variants dent vaccine efficacies.
    - Persistent inflation causes Central banks to tighten policy prematurely at a time when consumers start feeling the pinch from higher inflation.
    - Policymakers get worried about the social implications of spiraling housing prices, and act to bring them down.
    - China's ongoing attempts to reset its relationship with the technology sector in pursuit of its "common prosperity" goals gets out of hand.
    - Tax rates rise globally as governments pursue tighter fiscal policies.
    - US-China relationship takes a turn for the worse.

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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