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Multi-Asset perspectives

Courtesy of Principal Global Investors

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October 2021

Market Summary

Macro

- **Global infections** rose 13m to **247 million** at the end of October'2021, as the pace slowed relative to 16m new cases in September. **Global Fatalities** grew slower than new cases, reaching 5 million which softened the mortality rate to 2%. Our **Global Stringency Index** that uses Oxford data, improved slightly to 59 (100=highest stringency) as diminishing cases and vaccine efficacy in preventing serious illness encouraged reopenings.
- The **Global vaccination count** increased 765mn doses to 7bn, though the pace was slower than prior month's 963mn as several countries got closer to vaccinating a majority of their adult-age populations. UAE retained the lead, with 191 doses per 100, followed by Chile (189 per 100), Singapore (175), Israel (173) and China (162). US (128) remained behind its European peers and Japan (both around 150). Encouragingly, several EM countries that lagged the drive in the initial stages, caught up further with the early starters.
- **Economic activity remained strong, but momentum slowed**. Our provisional global Manufacturing PMI was stable at 55.9. Global industrial output growth slowed to 5.4% yoy in August'2021 from 7.4%yoy the month prior on fading base effects and hit to output from constrained supply chains. While our leading indicator continues to suggest above-trend growth, the directed path is towards trend growth in coming months. Global financial conditions tightened a tad from very accommodative levels, driven by wider credit spreads, higher rates and slowing monetary growth. Global Macro-economic surprises were negative for a sixth consecutive month, with all regions recording negative surprises.
- **Global inflation** continued its ascent, reaching 3.3%yoy in September'2021 with 21 out of 29 countries recording higher readings. US **5yr breakevens** briefly touched 3.0% before closing at 2.9% (40bps for the month) as markets started pricing a higher-for-longer inflation scenario on the back of sustained supply-side bottlenecks and a likely pick-up in services/housing inflation as the economy reopens. **Our leading indicator suggests that inflation will fade in coming months, though levels will remain elevated relative to policy targets in most countries.**
- **Our cross-asset volatility** indicator eased, as equity volatility dropped noticeably. Fixed income volatility and crude oil volatilities remained elevated, however.

Bottom-up

- Earnings revision momentum, which has been strong since 4Q'2020, stayed positive but showed signs of ebbing as analysts factor in a complex environment of strong demand, strong consumer balance sheets but persistent supply bottlenecks, rising wage costs, and waning fiscal/monetary support. MSCI AC World's **expected EPS** CAGR for 2021-22 increased just 1% to 25%, with 2021 at 46% (↑2%) but 2022 at just 6% (↓1%). MSCI AC World's **3m EPS change** dropped to 1.5% in October'2021 from 3.2% in September'2021. The 3m Earnings Revisions Ratio too eased to 0.56 from 0.59.
- On the fixed income side, the ratio of **global credit rating upgrades** to total changes was broadly unchanged at 58%.

Valuations

- **Equity** valuations remained expensive as market recovered. US, Growth and Large Caps remained as expensive as they have been relative to their cohorts.
- **IG and HY** spreads were stable but remained expensive.
- **US 10-yr treasury yield** cheapened 6bps but it was still leaning towards expensive in both our fundamental fair value and time-trend models.

Markets

- **Multi-Assets**: Our global multi-asset index gained 2.4% in October'2021 to expand YTD'2021 return to 7.7%. Equities and commodities were contributed positively while fixed income returns were slightly negative.
- **Equities** rose by 5.1%, led by a 6.9% rally in US. While gains were broad based, DMs outperformed EMs that were dragged down Brazil, Mexico and Korea, all of which clocked negative returns.
- **Fixed income**: PGAA's Global policy rate indicator increased to 1.22% with 8 hikes and 1 cut during the month. PGAA's Global Sovereign 10-yr yield indicator ended 19bps higher at 2.59%. 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$ depreciated by 0.4% against a broad trade-weighted currency basket as equities and commodities returned to the risk-on mode after a challenging September.
- **Commodities**: The GS commodity index was up 5.5%. Higher energy prices contributed the most in a month that saw most commodities rise. A cold winter, declining new COVID-19 cases, and reluctance by OPEC to adjust output higher to match rising demand kept supporting oil prices.

Looking Ahead

1. **Growth – strong but expect the moderation ahead**
   The global economy continues to grow, aided by supportive financial conditions, strong consumption demand by global consumers sitting on accumulated savings and sizeable wealth effects due to rising asset values, declining new cases and rising vaccinations. The world is moving towards accepting COVID-19 as an endemic, with vaccinations (including booster doses) and precautions the preferred tools globally. Most governments cannot afford lockdowns and continue to vaccinate their populations rapidly. Emerging markets in particular are catching up fast. China's vaccination doses reached 163% of its population, Chile's 189%, UAE's 192%, Malaysia's 153%, Brazil's 131% and India's 78% as global doses crossed the 7bn mark. However, growth continues to face two key risks: a) the default by Evergrande is bound to impact growth adversely in China with property transactions (about 20% of its GDP directly and indirectly) already slowing dramatically and b) the continued strength in inflation driven by supply bottlenecks, and higher oil/gas prices could slow down consumption after the pent-up demand gets filled.

2. **Inflation**
   Inflation remains a key area of focus for us, with our downside growth scenario envisioning a rapid monetary response to higher inflation which hastens a recession. While our leading Indicator is predicting a tail-off in inflation starting early next year, the risks from a further increase in commodity prices, supply bottlenecks, and the demand generated by the vast pool of consumer savings cannot be ignored.

3. **Monetary policy & global financial conditions**
   Global monetary policy remains easy, but the path ahead is bound to see calibrated withdrawal of accommodation. EMs have already taken the lead, with the US Fed following suit by announcing a tapering of its asset purchase program @$15bn a month through June (they'd been buying assets @$120bn a month till October). It is also likely to start adjusting rates higher in 4Q'2022 in response to substantial progress in its inflation goals. 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. The real risk to risk assets stems from central banks changing their assessment of inflation from transitory to structural, which could invite a more rapid policy response.

4. **Valuations**
    - **Global risk premiums remain low**. Risk-free rates also remain suppressed.
    - **Equity** valuations remain rich though base effects have reduced their expensiveness in the past few months. An environment of deeply negative real yields and above-trend growth prospects
    - 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. Investor positioning remains biased towards reflation beneficiaries in equities, bonds and commodities. Only in FX are investors positioned for stress (a huge net US$ long position).

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**: Reducing cases, acclerating vaccinations in emerging markets, and high efficacy in the 6-9 months post vaccination give us hope that the world is finding a way to deal with the virus. Consequently, we expect re-openings to pick up in coming months even if new cases maintain at current level, which causes us to upgrade this factor to "**mildly positive**" from neutral.
    b. **Growth**: Both macro and bottom-up growth environments remain strong, though the second order derivative (rate of change) has weakened. 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 are not insignificant**.
    c. **Monetary policy** – Central banks are moving towards a gradual policy normalization, with DMs following EMs. Overall financial conditions still remain easy, causing us to retain this factor at "**positive**".
    d. **Fiscal policy** –US authorities are working hard to strike a deal to inject more stimulus in the economy through infrastructure spending even though most of this could be paid for by additional revenue generation measures. 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 higher commodity prices and a rapidly slowing property sector. Overall, we still keep this factor as "**mildly positive**".
    e. **Valuations** – Low risk premiums worry us, which causes us to keep this factor at "**negative**". However, lack of meaningful returns from risk-free alternatives should keep investors interested in equities and corporate risk assets as long as financial and liquidity conditions remain easy, and forward-looking growth outlook positive.
    f. **Technical factors**: Technical signals are bordering the overbought zone again after a moderation in September. We reduce this to "**mildly negative" from "neutral".**

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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