Multi-Asset perspectives

Courtesy of Principal Global Investors

November 2021

Highlights

Macro

- **Global infections** rose 16mn to **263 million** by the end of November'2021. The pace increased from October's 13mn as European cases reaccelerated from a 70k per day pace to 150k. A new strain, Omicron, which is seemingly more infectious than the Delta strain emerged. Encouragingly, **Global Fatalities** rose at a slower pace, reaching 5.2 million with the mortality rate easing 4bps to 1.98%. **Our Global Stringency Index,** which uses Oxford data, was flat at 57 (100=highest stringency). While U.S. reopenings indicator improved from 50 to 45, new restrictions in Europe pushed its score to 63 from 53.
- **The Global vaccination count** increased 972mn doses to 8bn, faster than last month's 765mn as more countries gave nods to booster shots. In terms of doses per 100 people, Chile was in the lead at 210, followed by UAE at 198, China at 179, Israel at 176 and Singapore at 175. U.S. at 140 trailed both Europe and Japan within the developed world. Encouragingly, EM countries that lagged the vaccination drive in the initial stage, continued to catch up at rapid speed.
- **Economic activity was resilient, particularly in the U.S. and Europe.** Our provisional global Manufacturing PMI rebounded to 56.4 from 55.9 as 96% of the countries remained in expansion. PGAA's Global Economic Surpises Index ended a six-month streak of misses. Our global industrial production leading indicator was rangebound on lower freight rates and weaker new orders, but it continues to suggest above-trend growth. We expect it to normalize towards trend as we move into 2022. Easing supply bottlenecks, however, present an upside risk. Global financial conditions tightened from very accommodative levels (higher policy rates, tighter spreads, and higher volatility) as markets turned cautious from the unexpected pivot towards a faster pace of monetary policy normalization by Fed Chair Powell and uncertainty posed by Omicron.
- **Global inflation** continued its ascent, reaching 3.8%yoy in October'2021 with 23 out of 29 countries recording higher readings. U.S. **5yr breakevens** had a roller-coaster run in November, touching an intra-month high of 3.2% before closing at 2.8% (-12bps for the month) in response to a hawkish shift by the U.S. Fed, which is likely to announce a faster pace of tapering in December in response to persistently high inflation. **Our inflation leading indicator suggests that inflation will fade in coming months, though levels will remain elevated relative to policy targets in most countries for a prolonged period of time.**
- **Our cross-asset volatility indicator** spiked up to 118% of its long-term average, as a streak of negative news (weak China earnings, Omicron concerns, Fed tightening, no positive takeaways from the Biden-Xi virtual summit) hit markets at a time when liquidity is thin due to U.S. Thanksgiving holidays. Equities and crude oil volatility rose more than fixed income and currency.

Bottom-up

- Earnings revision momentum, which has been strong since 4Q'2020, eased further as analysts factored 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 remained at 25%, with 2021 at 47% (↑1%) and 2022 flat at just 6%. MSCI AC World's **3m EPS change** dropped to 0.4% in November'2021 from 1.6% in October'2021. The **3m Earnings Revisions Ratio** eased to 0.54 from 0.56 but continued to show more upgrades than downgrades.
- **3Q'2021 earnings surpise** was strong in U.S. (9.8%), Western Europe (10.7%) and Japan (19%). But China earnings (Shanghai Composite) missed by 4% as regulatory headwinds remained.
- On the fixed income side, the ratio of **global credit rating upgrades to total changes** was stable at 58%.

Valuations

- **Global equity valuations** eased but stayed expensive as U.S. valuations remained expensive. After the recent correction, MSCI EM moved into the fair value zone.
- **IG and HY** spreads widened but remained expensive by historical standards.
- **U.S. 10-yr treasury** yield declined -11bps, and was still leaning towards expensive on both fundamental and time-trend fair value models.

Markets

- **Multi-Assets:** Our global multi-asset index lost -2% in November'2021 to reduce YTD'2021 return to 5.5%. All asset classes ended in red with commodities performing the worst.
- **Equities** dropped by -2.4% as 72% of the markets we track ended with losses. Growth outperformed as Omicron cast a shadow on reopening oriented value stocks. The median local currency return was -3.1% which shrank the median YTD'21 return to 10.8% with 88% of markets clocking positive return.
- **Fixed income:** PGAA's Global Policy Rate indicator increased to 1.23% with 8 hikes and 1 cut during the month. PGAA's Global Sovereign 10-yr Yield indicator ended 12bps lower at **2.44%** as yield curves flattened. High yield and investment grade spreads widened 50bps and 12bps respectively. Returns were negative from most fixed income segments.
- **Currencies:** The U.S.$ appreciated by 2.1% against a broad trade-weighted currency basket. Our real effective exchange rate-based currency valuation models suggest U.S.$ is one of the most overvalued currencies. Turkish Lira, Mexican Peso and the Japanese Yen remain cheap.
- **Commodities:** The GS commodity index was down -11%, chiefly driven by lower energy prices (energy sub-index dropped -19%) as the release of 70-80m barrels of strategic petroleum reserves by U.S., India, Korea, Japan and China caused speculators to reduce net longs in crude. Demand concerns due to Omicron and a hawkish shift in Fed stance also played a part. Despite the drop, commodities remain on course for a strong year, with the broad measure showing a gain of 28% YTD'2021.

Looking Ahead

1. Growth is strong but expect normalization in coming quarters

The global economy continues to grow, aided by still low interest rates and strong pent-up demand by global consumers sitting on accumulated savings and sizeable wealth effects due to the jump in asset values (equities and housing) and rising vaccinations (we crossed the 8bn mark globally). There are also some signs that supply bottlenecks are easing: reduction in freight rates, lower commodity prices, and commentary by some companies who guided for production recovery in their recent earnings releases. This bodes well for corporate efforts to rebuild inventories which are running fairly low relative to sales. Chinese policy stance has probably shifted a little towards 'support for growth' to contain fallout from the Evergrande fiasco. On the other hand, financial conditions have started to tighten as global central banks are shifting their stance to inflation control, and Omicron poses a short-term risk. Political risks remain too – the virtual summit between Presidents Joe Biden and Xi Jinping yielded little and relations between the two nations remain strained. Chinese new economy companies, key drivers of wealth creation in China, remain stressed by ongoing regulatory tightening. And the market confidence in Chinese property companies remains fragile, with the average Chinese High Yield U.S.$ bond trading at a 35% discount in the secondary markets.

2. Inflation

Inflation remains a key area of focus for U.S., with our downside growth scenario envisioning a rapid monetary response to higher inflation which hastens a recession. Even our baseline scenarios now entail a faster pace of monetary policy normalization in response to inflation that's been stickier than our initial assessment. Though our leading Indicator continues to predict a tail-off in inflation starting early next year, risks remain.

3. Monetary policy & global financial conditions

Global monetary policy remains easy, but the path ahead will likely see a faster normalization of policy in response to inflation. EMs have already taken the lead, with the U.S. Fed following suit. They are likely to start raising policy rates by the middle of next year after winding down their asset purchase program at a faster pace. While we do expect higher policy rates and yields going forward, we don't think policy makers will push real policy rates into positive territory until late 2024, which should keep risk assets supported in an environment of above-trend growth.

4. Valuations

- **Global risk premiums remain low.** Risk-free rates also remain suppressed.
- **Equity** valuations remain rich though their expensiveness has reduced in the past few months. An environment of deeply negative real yields and above-trend growth prospects should continue to support equities despite rich valuations, though the path has become more uncertain given the expected tightening in financial conditions.
- **Corporate spreads** remain tight and the room for them to compress further is minimal. It is also hard to see a significant widening either, given that companies remain in great health and the hunt for yield remains as strong as ever.
- In **Currencies,** the U.S.$ remains on the expensive side but a reset of expected Fed funds rate path, and policy mistakes by some EMs (Turkey, Brazil, Mexico, Chile) could keep the greenback supported.

5. **Sentiments & technical indicators**

Equity inflows remained strong and retail participation high. Investor positioning remains biased towards reflation beneficiaries in equities and bonds but has come off in commodities and currencies (a huge net U.S.$ 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 and tightening financial conditions. Our checklist of various factors stacks up as:
   a. **Return-to-Work strategies -** Accelerating vaccinations in emerging markets is a big positive though risks from new variants like Omicron can slow the re-opening process, which causes U.S. to downgrade this factor to **"neutral"** from "**mildly positive".**
   b. **Growth -** Both macro and bottom-up growth environments remain strong, though the second order derivative (rate of change) will weaken. Consumers still retain large savings buffers and there exists a potential for more U.S. fiscal stimulus through the Build Back Better Plan, allowing us to keep this factor as **"positive". However, risks from higher inflation, weaker housing affordability, and tighter financial conditions are building up.**
   c. **Monetary policy** – Central banks are advancing further in normalizing policy, with the U.S. Fed following EMs. Europe and Japan, however, remain far from starting their tightening cycles. Overall, while financial conditions remain easy, the second order effects are headed in a tighter direction, which causes us to downgrade this factor to **"mildly positive"** from **"positive".**
   d. **Fiscal policy** – U.S. authorities are working hard to strike a deal to inject more stimulus in the economy through infrastructure spending though most of this will likely 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, may start loosening its purse strings at the margin. Overall, we 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 –** Some froth seems to have come off technical indicators, but they remain a little stretched. We keep this factor at "**mildly negative".**

7. **Key risks:** The key risks to our pro-risk stance are -
   - New variants dent vaccine efficacies, causing governments to reimpose restrictions.
   - Persistent inflation forces central banks like the U.S. Fed to front-load policy normalization at a time when consumers start feeling the pinch from higher inflation. High inflation, waning growth and tightening financial conditions could cause market sentiment to sour.
   - Policymakers get worried about the social implications of spiraling housing prices and act quickly to bring them down.
   - China's property sector woes and regulatory tightening start hitting the broader economy.
   - Tax rates rise globally as governments pursue tighter fiscal policies.
   - U.S. - 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. Fixed-income investment options are subject to interest rate risk, and their value will decline as interest rates rise. Equity investment options involve greater risk, including heightened volatility, than fixed-income investment options. Investment in foreign currency can result in losses and values may fluctuate based on foreign exchange rates, exchange restrictions, or other actions of governments or central banks. Commodity futures contracts generally are volatile and not appropriate for all investors.

Important information
This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account. Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided.

This material may contain 'forward-looking' information that is not purely historical in nature and may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

Proprietary model output is based upon certain assumptions that may change, are not guaranteed, and should not be relied upon as a significant basis for an investment decision. Forecasts for each asset class can be conditional on economic scenarios; in the event a scenario comes to pass, actual returns could be significantly higher or lower than forecasted. Because of the inherent limitations of all models, potential investors should not rely exclusively on the model when making an investment decision. Forecasts of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice.

The information provided here is neither tax nor legal advice. Investors should speak to their tax professional for specific information regarding their tax situation.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation

Disclaimer:
Ahli United Bank B.S.C.
Bahrain: The views contained herein has been obtained from sources that **Ahli United Bank B.S.C. ("AUB"**) deems to be reliable but Ahli United Bank B.S.C. makes no representation about the accuracy, completeness or timeliness of any information prepared by a third party and assumes no liability for the reliance thereon. The opinions and predictions expressed in the materials are subject to change without prior notice and has not been prepared by or with the involvement of Ahli United Bank B.S.C.; however, Ahli United Bank B.S.C. does not independently verify or guarantee its accuracy or validity. Subject to any contrary provisions of applicable law, Ahli United Bank B.S.C. and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only and derived from numerous sources, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. IMPORTANT – If you are in any doubt about the contents of this document you should seek independent professional advice. AUB will not act and has not acted as your legal advisor to you in connection with this, and/or any related transaction and no reliance may be placed on AUB for advice or recommendations and/or solicitation of any sort. Ahli United Bank B.S.C. is licensed as a conventional retail bank by the Central Bank of Bahrain ("CBB"). For additional information about Ahli United Bank B.S.C., please visit www.ahliunited.com/bh.

Dubai International Financial Center: Ahli United Bank B.S.C. (DIFC Branch) is an entity duly authorised and regulated by Dubai Financial Services Authority ("DFSA") with its registered office at 1402 Al Fattan Currency House Tower 2 DIFC, Dubai, UAE. This document is being distributed for general information only. It does not constitute research material, independent research, an offer, recommendation or solicitation to enter into any transaction or adopt any hedging, trading or investment strategy, in relation to any securities or other financial instruments. It does not take into account the specific investment objectives, financial situation or particular needs of any particular person or class of persons and it has not been prepared for any particular person or class of persons. Please note that Ahli United Bank B.S.C. (DIFC Branch) offers financial products or services only to persons qualifying as Professional Clients or Market Counterparties under the DFSA rulebook. This information may not be relied upon or distributed to Retail Clients.

Egypt: The views contained herein has been obtained from sources that **Ahli United Bank (Egypt) S.A.E. ("AUBE")** deems to be reliable but AUBE makes no representation about the accuracy, completeness or timeliness of any information prepared by a third party and assumes no liability for the reliance thereon. The opinions and predictions expressed in the materials are subject to change without prior notice and has not been prepared by or with the involvement of AUBE; however, AUBE does not independently verify or guarantee its accuracy or validity. Subject to any contrary provisions of applicable law, AUBE and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only and derived from numerous sources, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. IMPORTANT – If you are in any doubt about the contents of this document you should seek independent professional advice. AUBE will not act and has not acted as your legal advisor to you in connection with this, and/or any related transaction and no reliance may be placed on AUBE for advice or recommendations and/or solicitation of any sort. Ahli United Bank (Egypt) S.A.E. is licensed and regulated by the Central Bank of Egypt. For additional information about Ahli United Bank (Egypt) S.A.E., please visit www.ahliunited.com/eg.