# Multi-Asset perspectives

Courtesy of Principal Global Investors

**December 2021**

## Highlights

### Macro

- **Global infections** rose 25mn to **288 million** by the end of December'2021. The 7-day average of new cases more than doubled from the prior month's 574k to 1312k (a new high) as the more infectious Omicron strain spread in more countries. **Global Fatalities** rose at a much slower pace, reaching 5.4 million. The mortality rate eased 10bps to 1.89% as Omicron appears to be less deadly than earlier variants. **Our Global Stringency Index,** which uses Oxford data, was flat at 61 (100=highest stringency) but risks are skewed to the downside as several countries take restrictive steps to slow the viral spread.
- **The Global vaccination count** increased 1159mn doses to 9.2bn, faster than last month's 972mn as more countries approved booster shots. Rapid rising cases triggered a new vaccination wave in Europe where most large countries reported doses equivalent to 25-30% of their population. In terms of doses per 100 people, UAE was in the lead at 241, followed by Chile at 222, UK at 193, China at 192 and France at 184. U.S. at 151 trailed both Europe and Japan within the developed world. EM countries continued to catch up with their developed counterparts at rapid speed.
- **Economic activity was resilient, but momentum slowed.** Our provisional global Manufacturing PMI eased to 55.5 from November's 56.4 (US PMI dropped from 61.1 to 58.7 but internals remained robust). PGAA's Global Economic Surprises Index turned negative in December, dragged mainly by Europe and Japan. Our Global Industrial Production Leading Indicator improved slightly on stronger new orders and continues to suggest above-trend industrial growth. While we expect it to normalize towards trend this year, easing supply bottlenecks present an upside risk. On the other hand, fresh supply disruptions from the spreading Omicron could add downside risks. Global financial conditions eased at the margin as spreads tightened and market volatility eased. During 2021, they tightened from 0.69 to 0.47 but remained in the "easy" zone. The U.S. Fed's monetary tightening cycle implies further tightening in 2022 but levels should remain "easy".
- **Global inflation** continued its ascent, reaching 4.4%yoy in November'2021 with 26 out of 29 countries recording higher readings. U.S. **5yr break-even** increased by 10bps to 2.91. **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 an extended period.** In response to persistently high inflation, the **U.S. Fed** decided to double the pace of tapering to $30bn per month and will most likely start hiking in 2Q'2022 itself. The Fed forecasts now show a median of 3 hikes (75bps) in 2022.
- **The People's Bank of China (PBOC) cut its 1yr Loan Prime Rate (LPR) by a symbolic -5bps to 3.8%** (its first cut since Apr'2020), following a -50bps cut in banks' reserve requirements (RRR). The 5-yr rate was left unchanged at 4.65%, suggesting that policy has made a cautious pro-growth turn.
- **Our cross-asset volatility indicator** eased towards its historical median as markets rallied in the hope that Omicron is unlikely to damage growth despite its rapid spread. EM currency volatility remained high due to the continued rout in Turkish Lira, as monetary policy continued to dance to a populist, political tune. For good reason, the Lira ended as the worst performing currency during the year, with the US$ jumping 79% against it.

### Bottom-up

- Earnings revision momentum improved slightly in December but an environment of strong demand, strong consumer balance sheets but persistent supply bottlenecks, rising wage costs, and waning fiscal/monetary support may challenge it in the months ahead. MSCI AC World's **expected EPS** CAGR for 2021-22 remained at 25%, with 2021 at 48% (↑2%) and 2022 at just 6% (unchanged). MSCI AC World's **3m EPS change** rose to 2.1% in December'2021 from 0.2% in November'2021. The **3m Earnings Revisions Ratio** was stable at 0.53, with upgrades remaining higher than downgrades.
- On the fixed income side, the ratio of **global credit rating upgrades to total changes** eased to 57%, as an improvement in investment grade (61% to 63%) was overshadowed by a weakening in high yield (56% to 54%).

## Valuations

- **Global equity valuations** remained expensive, with DMs (led by US) far more expensive than EMs. LatAM remained the cheapest region.
- **IG and HY** spreads tightened and remained expensive by historical standards.
- **U.S. 10-yr treasury** yield rose 7bps but was still leaning towards expensive on both our fundamental and time-trend fair value models.

## Markets

- **Multi-Assets:** Our global multi-asset index rose 2.3% in December to expand 2021 return to 8.0%. For the year, global commodities led the return tables, followed by Equities as core fixed income delivered negative returns.
- **Global Equities** gained 4% with 85% of the markets ending in green. Europe and value outperformed as markets took Omicron fears in their stride. The median local currency return was 2.9% which expand the median 2021 return to 14.7% with 88% of markets clocking positive return.
- **Fixed income:** PGAA's Global Policy Rate indicator increased to 1.3% with 11 hikes and 1 cut during the month. PGAA's Global Sovereign 10-yr Yield indicator ended 6bps higher at **2.5%** but yield curves flattened as the global 2-10yr spread narrowed to just 56bps. U.S. high yield and investment grade spreads tightened -54bps and -7bps respectively. Asian high yield spread narrowed -255bps.
- **Currencies:** The U.S.$ depreciated by 0.8% against a broad trade-weighted currency basket as risk markets turned risk-on after a weak November. For the year, however, the US$ gained against 27 of the 30 currencies we track it against, with substantial gains against most currencies in Latin America, EEMEA and against JPY. Our real effective exchange rate-based currency valuation models suggest U.S.$ remains overvalued but carries tailwinds from a hawkish U.S. Fed. Turkish Lira, Mexican Peso, Japanese Yen, and the HK$ remain cheap.
- **Commodities:** The GS commodity index jumped 7.6% (37% for 2021), driven by a recovery in energy prices which rose 11% to their return for 2021 to 54%. Supply discipline amidst exploding goods demand as consumers shifted consumption preferences from services to goods due to COVID-19 made it the best year for commodities since 2009 when the index had jumped 50% following the 2008 slump.

## Looking Ahead

### 1. Growth – above trend but expect normalization

The global economy continues to grow, aided by still easy financial conditions, strong pent-up demand by global consumers sitting on accumulated savings and large wealth effects due to the jump in asset values (equities and housing), and restocking demand by companies that are sitting on low inventories relative to above-trend goods sales. Rising vaccinations (we crossed the 9bn mark globally) provide hope that newer variants like Omicron will not be as deadly as the earlier ones, both in terms of mortality and their economic impact. There are also some signs of an easing in supply bottlenecks (stabilization in freight rates, a decline in prices paid component of US Manufacturing ISM, a drop in its delivery-delays component, and commentary by some companies about production recovery) which bodes well for industrial activity. Chinese policy stance has probably shifted a little towards 'support for growth' to contain fallout from the housing meltdown. On the other hand, financial conditions are tightening as several global central banks have shifted their stance to inflation control. Political risks remain too – developments in Ukraine and the continued strain in Sino-US relationship (though efforts continue to find a way to reduce certain tariffs) can present tail risks. Chinese new economy companies, key drivers of wealth creation in China, remain stressed, with the latest scare in the form of large tech companies reducing stakes in other tech firms. Also, the market confidence in Chinese property companies remains fragile, with the average Chinese High Yield US$ bond still trading at a 25% discount.

### 2. Inflation

Inflation remains a key area of focus for policy makers and us, too. Our downside scenario envisions rapid monetary response to stubborn inflation which hastens a recession. Even our baseline scenarios now entail a faster pace of monetary policy normalization (end of Fed QE by 2Q'2022, followed by 3 rate hikes in the year). Though our leading Indicator continues to predict a tail-off in inflation starting early next year, risks remain, particularly if the fast-spreading Omicron starts disrupting the supply of labor, goods, and services.

**3. Monetary policy & global financial conditions**

Global policy rates will move higher in 2022 as the U.S. Fed moves towards inflation control to prolong the recovery. While global financial conditions will tighten, their level should remain accommodative. Also, we remain skeptical that real policy rates will turn positive anytime soon, which should keep risk assets supported if growth holds above trend.

**4. Valuations**

- **Global risk premiums remain low.** Risk-free rates also remain suppressed but will move higher in 2022.
- **Equity** valuations remain rich. An environment of deeply negative real yields and above-trend growth should continue to support equities despite rich valuations, though tightening financial conditions will limit gains.
- **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 are well-funded and remain in good health given strong nominal growth, and the hunt for yield from investors remains strong.
- In **Currencies,** the US$ remains expensive. A faster pace of rate hikes and policy mistakes by some EMs (Turkey, Brazil, Mexico, Chile) could keep the greenback supported.

**5. Sentiments & technical indicators**

Equity inflows were exceptionally strong in 2022 ($928bn), and retail participation was very high. Investor positioning, however, softened in the last few weeks, reducing the technical froth in the market.

6. **Summarizing our thoughts on risk assets:** We retain a mildly 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 could slow the re-opening process. 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. Consumers still retain large savings buffers and there exists some chance that the failed Build-Back-Better (BBB) initiative may be revived in 1Q'2022 which will add some fiscal stimulus. While keeping this factor as **"positive", we recognize increasing risks from higher inflation, weaker housing affordability, and tighter financial conditions.**

   c. **Monetary policy** – Central banks will tighten monetary policy, led by the U.S. Fed. Europe and Japan, however, remain far from starting their tightening cycles. Overall, while financial conditions (level) remain easy, the second order effects are headed in a tighter direction. We keep this factor at "**mildly positive**" for now but are keeping a close eye on hawkish central bank actions.

   d. **Fiscal policy** – U.S. authorities couldn't get additional fiscal spending approved through the Build-Back-Better plan. While it may be revived during 1Q'2022, there is also a chance that political differences within the Democrats reduce its fiscal impact considerably. In the Euro Area, spending from the Recovery fund should 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".**

   f. **Technical factors –** Some froth has come off technical indicators, but they remain somewhat stretched. A deeper correction is probably needed to flush out positions more meaningfully. Overall, 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.
   - Persistently high inflation forces Central banks to turn decidedly hawkish and front-load policy normalization just when growth starts rolling off.
   - Policymakers get worried about the social implications of spiraling housing prices, and act to bring them down.
   - China's technology and property sector woes start hitting the broader economy.
   - Geopolitical risks could rise. U.S. - China relationship and U.S.-Russia relationship can take a turn for the worse.
   - Tax rates rise globally as governments pursue tighter fiscal policies.

**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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