Multi-Asset perspectives

Courtesy of Principal Global Investors

January 2022

Highlights

Macro

- **Global COVID infections** rose 31% to **378 million** by the end of January'2022. The 7-day average of new cases jumped from 1.3 million to 3.3 million, though it was 4% below the intra-month high of 3.43 million. Omicron variants (BA.1 and BA.2) spread rapidly but there were signs that the wave was peaking in US, India, Canada, Spain while staying high in UK, Germany, Brazil, Chile, and several smaller countries. Encouragingly, however, the variants are much less virulent, with **Global Fatalities** rising just 4% versus a 31% rise in cases. The mortality rate eased -30bps to 1.50%. **Our Global Stringency Index,** which uses Oxford data, worsened from 63 to 67 (100=highest stringency) due to higher restrictions in a few countries, which was largely on expected lines.
- **The Global vaccination count** increased a billion to 10.15bn, tad slower than previous month's 1.16bn. We are not surprised as the median country in our coverage is already at 194 does per 100 population, implying significant distance has already been travelled. While more countries are adopting booster shots and extending vaccines to younger populations, the future trajectory of new doses should be lower, unless a virulent COVID variant forces a modified vaccine upon humanity. While EM countries continued to catch up with their developed counterparts in vaccinating populations, Europe showed the largest increase during the month, which wasn't surprising given the surging cases in the continent.
- **Economic activity was resilient,** but the most likely path ahead is one of normalization (lower). Our provisional global Manufacturing PMI eased to 55 from 55.5 with both DM PMI (57.4) and EM PMI (51.1) experiencing similar drops. Our Global Industrial Production Leading Indicator eased marginally but remained above trend. While we expect it to move towards trend this year, restocking by companies presents short-term upside risk if Omicron-induced restrictions start easing. PGAA's Global Economic Surprises Index stayed negative in US and Europe but turned marginally positive in China and Japan.
- **Global financial conditions** tightened due to higher rates, wider spreads, higher volatility, and weaker monetary growth, but levels remained in the "easy" zone. We expect more tightening in 2022 as policy rates are headed higher globally. The **US Fed** was hawkish in its Jan'2022 meeting, preparing the market for a series of rate hikes and balance sheet contraction as it attempts to restore credibility by bringing inflation down. However, China's **PBOC went the other way, cutting its 1yr & 5yr Loan Prime Rates (LPR) by -10bp and -5bps to 3.7% and 4.6% respectively,** as it attempts to soft land the economy hurt by property sector stress.
- **Global inflation** ticked up to 4.5% in Dec'2021 from 4.4% the prior month, with 18 out of 29 countries recording higher readings. U.S. **5yr break-even** was stable at 2.89% though a hawkish Fed commentary did ease 10-yr break-even -10bps to 2.49%. **Our inflation leading indicator continues to suggest that inflation will fade in coming months, though levels will remain elevated relative to policy targets in most countries.** Risks to that path emanate from persistence of supply-side bottlenecks, which have had a big hand in handing pricing power to companies.
- **Our cross-asset volatility indicator** jumped above its historical average as risk assets sold off in response to tightening financial conditions and building risks along the Russia-Ukraine border. While EM currency volatility eased, volatility in DM currency pairs, equities, bonds and commodities rose, particularly in equities where our measure jumped 54% during the month. Higher volatility tends to bring negative flows, as leveraged, risk-parity and volatility- targeting strategies are forced to reduce risks.

Bottom-up

- After 15 months of continuous upgrades, earnings revisions seem to be stabilizing. MSCI AC World's **expected EPS** CAGR for 2022 remained at 7% (2021 is likely to end with 46-48% yoy growth). MSCI AC World's **3m EPS change** for 2022 was stable at 1%. The global **3m Earnings Revisions Ratio** was stable at 0.54 (upgrades > downgrades). Energy and materials are seeing net upgrades due to the continued strength in commodity markets.
- On the fixed income side, though rating upgrades exceeded downgrades in January, it is hard to get a sense of developments as there were very few rating actions. At the end of the 2021 though, the ratio of **global credit rating upgrades to total changes** ended at 57% with investment grade at 63% and high yield at 54%.

Valuations

- **Global equity valuations** eased due to the large drawdown but remained on the expensive side, with DMs (led by US) far more expensive than EMs. Latin America remained the cheapest region.
- **IG and HY** spreads widened, reducing their expensiveness, and bringing them towards fair value.
- The **U.S. 10-yr treasury** yield jumped 27bps, taking it closer to fair value on our fundamental and time-trend fair value models.

Markets

- **Multi-Assets:** Our global multi-asset index dropped -2.9% in Jan'2022 as all risk assets barring commodities struggled. Higher yields and rising geo-political risks impacted sentiment adversely.
- **Global Equities** dropped -4.9% with 67% of the markets ending in red. The median local currency return was -2.3%. Latin America outperformed regionally while Value outperformed among styles. Technology and US small caps saw the largest drawdowns. While macro developments (rising inflation and higher yields) supported Value over Growth, retail capitulation was a key theme too, with investors exiting leveraged positions in the darlings of 2021.
- **Fixed income:** PGAA's Global Policy Rate indicator was stable at 1.3% (China's -10bp rate cut neutralized increases in Korea, Eastern Europe and Latin America). PGAA's Global Sovereign 10-yr Yield indicator ended 23bps higher at **2.71%** (26 out of the 27 countries we track had higher yields). Yield curves were stable, with the global 2-10yr spread at 58bps. US high yield and investment grade spreads widened 14bps and 59bps respectively. Asian high yield spread outperformed, widening just 15bps, but at 611bps, their spread to US HY (342bps) and Euro HY (354bps) remained wide by historical standards.
- **Currencies:** Rising US rate hike expectations and the risk-off sentiment led US$ higher versus 77% of the currencies we track it against, though gains were relatively mild. Latin America outperformed as its currencies rose against the greenback. Our real effective exchange rate-based currency valuation models suggest that the U.S.$ remains overvalued. Turkish Lira, Mexican Peso, Japanese Yen, and the HK$ remain cheap.
- **Commodities:** The GS commodity index jumped 11%, driven by energy prices which jumped 17%. The oil market remains tight (the Department of Energy's estimate of supply-demand imbalance in global crude and liquid fuels rose to about 3% of demand). Fears that a Russian invasion of Ukraine would tighten the market further weighed heavily, too.

Looking Ahead

1. A Growth taper

The global economy continues to grow, aided by still easy financial conditions, strong pent-up demand by global consumers and large wealth effects from higher asset values. However, we feel it is entering a period where growth stays above trend but starts declining, as monetary and fiscal effects that boosted growth in the immediate aftermath of COVID start fading. Risks to growth are balanced. On the upside, companies that are running light inventories relative to sales, could restock at a faster pace, and Chinese policy easing could push growth higher than our expectations. On the downside, ebbing consumer confidence due to inflation, and persistence of bottlenecks could cause growth to disappoint.

2. Inflation

Inflation remains the most important metric for policymakers and us. The US Fed's hawkish tilt was entirely driven by inflation that's well above target, even after accounting for supply-induced price spikes. It is unlikely they will back off unless expectations get back into the 2-2.25% range they are comfortable with, even if growth slows more than expected. While our leading indicator continues to predict a tail-off in inflation, risks remain if supply side factors (labor, goods, and services) remain tight.

3. Monetary policy & global financial conditions

Global policy rates will move higher in 2022 and some of the excess liquidity will be removed as focus shifts from growth to inflation in most of the developed world. China, though, is likely to be an exception as it refocuses on growth after a year of tight monetary/fiscal policy directed at curbing excesses in its property sector. While global financial conditions will tighten, their level should remain accommodative with real interest rates still in negative territory in the DM world.

4. Valuations

- **Global risk premiums expanded a tad in January but remained low by historical standards.** Higher risk-free rates through the course of 2022 could present an anti-fragile alternative to investors, though the need for higher yield is likely to keep them interested in risk assets.
- **Equity** valuations cheapened in January but remained rich. Above-trend growth and strong earnings remain supportive factors which should cause equities to overcome a tightening in financial conditions.
- **Corporate spreads** widened towards fair value as risk-off gripped markets. However, given nominal growth, and the fact that the corporate sector is in good shape and well-funded, we don't expect too much widening. Besides, the hunt for yield from investors remains strong.
- In **Currencies,** the US$ remains expensive which should support risk-taking. However, we are cognizant of risks if U.S. financial conditions tighten too fast, which could draw flows back into the greenback.

5. Sentiments & technical indicators

The market correction in January tilted the technical positioning noticeably, with retail investor expectations and positioning turning on its head (AAII's retail investor bull-bear sentiment dropped to -30, its lowest in 10 years, US Equity Put/Call ratio jumped to 1.06, and risk-parity and volatility targeting strategies were forced to reduce risks).

6. **Summarizing our thoughts on risk assets:** We still retain a mildly pro-risk stance in our asset allocation framework while being conscious of threats from inflation and tightening financial conditions. Our checklist of various factors stacks up as:

    a. **Return-to-Work strategies –** Omicron seems to have peaked in many parts of the world. Vaccination rates continue to rise and even more importantly, vaccines are working. The world is learning to live with the virus, judging by the limited amount of disruption that this wave caused despite its magnitude. All considered, we keep 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 financial conditions are still easy though the path ahead will see them tighten. We keep this factor as **"positive",** though we are conscious of risks from higher inflation, weaker housing affordability, and tighter financial conditions.

    c. **Monetary policy** – Central banks are normalizing policy rates higher. Excess liquidity injected through asset purchases will also be withdrawn gradually. China, however, is on a different course and has changed its monetary policy stance to supportive. Europe and Japan aren't ready to start tightening yet. Overall, while financial conditions remain easy (level), the second order effects are headed in a tighter direction, which causes us to downgrade this factor to "**neutral**" from "mildly positive".

    d. **Fiscal policy** – A full-fledged Build-Back-Better plan looks unlikely in the current circumstances, though Congress may find common ground in supporting onshoring of chip production and reinstating the expired child care tax credits. In the Euro Area, spending from the Recovery fund should add marginally to fiscal spending. China, after months of tightening, may start loosening its purse strings to revive growth. Overall, we keep this factor as **"mildly positive"**.

    e. **Valuations –** Risk premiums are low, and if real rates rise meaningfully, they could expand, denting market returns. Overall, while we keep this factor as **"negative",** they are less so than almost all of 2021.

    f. **Technical factors –** The froth has surely come off after the correction in January, which causes us to upgrade this factor to "**neutral"** from "mildly negative".

7. **Key risks:** The key risks to our mild pro-risk stance are-

    - Persistently high inflation forces Central banks to choose inflation control even when growth starts to decline, leading to a stagflationary environment.
    - New variants dent vaccine efficacies, causing governments to reimpose restrictions which leads to renewed supply side pressures.
    - Policymakers take active steps to control spiraling home prices to send a social message.
    - Geopolitical risks worsen. U.S. - China and U.S.-Russia relationships 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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