Multi-Asset perspectives

Courtesy of Principal Global Investors

February 2022

I. Highlights

Macro

- **Global COVID infections** rose 15% to **437 million** by the end of February'2022. The 7-day average of new cases dropped sharply from 3.3 million to 1.6 million as the Omicron wave peaked in major developed countries though cases touched new highs in some Asian countries like South Korea, Hong Kong, Singapore and Malaysia. Encouragingly, the variants remained much less virulent, with **Global Fatalities** increasing at a much lower pace than the cases count, which took the mortality rate to1.36% from last month's 1.50%. **Our Global Stringency Index,** which uses Oxford data, remained largely range bound at 62.

- **The Global vaccination count** increased 626mn to 10.78bn, slower than previous month's 979mn as global average vaccinations reached 138 shots per 100. The median country in our coverage is already at 204 doses 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 trend even lower, unless a virulent COVID variant forces a modified vaccine upon humanity.

- **Economic activity remained resilient,** but the most likely path ahead is normalization (lower). Our provisional global Manufacturing PMI edged up slightly to 55.2 with both DM PMI (57.6) and EM PMI (51.1) ticking higher by similar magnitudes. 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 but the U.S. sub-index surprised to the upside as consumption, trade, housing and industrial releases beat expectations.

- **Global financial conditions** tightened significantly due to higher rates, wider spreads, higher volatility, weaker equities, and weaker monetary growth. Persistent inflation, which actually got a leg up during the month due to spiralling commodity prices, led rates higher despite a sell-off towards the end of the month on geopolitical risks. **Russia's invasion of Ukraine** drove credit spreads and volatility higher globally, with the effects strongest in Europe, followed by U.S. and China. UK and rest of EM were impacted less. We expect more tightening in 2022 as policy rates head higher globally.

- **Global inflation** ticked up to 4.6% in Jan'2022 from 4.5% the prior month, with 15 out of 29 countries recording higher readings. U.S. **5yr break-even** inflation rose 26bps to 3.15% as inflation outlook worsened with the spike in oil and agricultural commodity prices. **Our inflation leading indicator continues to suggest that inflation will fade in the coming months, though the path to normalization is extended given the commodity price move. Levels will remain elevated relative to policy targets in most countries for most of the year, too.** Additional risks could emanate from the re-emergence of supply-side bottlenecks as the world grapples with renewed supply side bottlenecks caused by sanctions on Russian entities.

- **In response to the Russian invasion of Ukraine, U.S. and other countries imposed new sanctions on Russia**, aiming to cripple the country economically by freezing its access to international financing and trade. Since Russia is a large net exporter of commodities like oil, natural gas, wheat, aluminum, nickel and a few others, the space caught fire as the West kept racheting up the scale of sanctions. There is a serious risk that shortages could flare prices further, hitting consumer pockets and growth adversely. For Central banks in the U.S. and Europe, rate increases remain the preferred policy option given how far behind the curve they are. However, the space could soon get clouded by declining growth as consumers retract at some point.

- **Our cross-asset volatility indicator** remained above its historical average as risk assets sold off in response to tightening financial conditions and the Russia-Ukraine war. Higher volatility tends to bring negative flows, as leveraged, risk-parity and volatility- targeting strategies are forced to reduce risk.

Bottom-up

- After several months of upgrades, earnings revisions are stabilizing. MSCI AC World's **expected EPS** CAGR for 2022 remained at 7% (2021 ended with 46% yoy growth). The global **3m Earnings Revisions Ratio** dropped to 0.51 (upgrades marginally higher than downgrades). MSCI AC World's **3m EPS change** for 2022 edged up to 1.6%. Energy and Materials saw net upgrades due to the continued strength in commodity markets.

- **Global credit rating upgrades to total changes** was at 56% by the end of Feb'22, similar to the end of 2021 though the volume of rating changes was low. US fixed income saw the best upgrade momentum with 70% of the total actions being upgrades. Asia pacific rating momentum was quite weak at 29%, mainly dragged lower by downgrades in Asia HY.

Valuations

- **Global equity valuations** eased due to the February drawdown but remained on the expensive side. DMs (led by US) remained expensive relative to EMs. Latin America remained the cheapest region globally. Russia's hammering as the world shut it out of banking operations took it to its cheapest ever at a Price/EPS (next 12 months) of just 3.0x, though we expect earnings cuts in the months to come.

- **IG and HY** spreads widened further, reducing their expensiveness. IG spread is close to its 10-yr median, but HY spread still has about 50bps more to get there.

- The **U.S. 10-yr treasury** yield increased 5bps to 1.83% after crossing 2% mid-month. Though still slightly expensive, it got closer to its fair value on our fundamental and time-trend fair value models.

Markets

- **Multi-Assets:** Our global multi-asset index dropped -1.8% in Feb'2022 as all risk assets barring commodities struggled. A hawkish Fed and a jump in geo-political risks impacted sentiment adversely.

- **Global Equities** dropped -2.6% with 65% of the markets ending in the red. The median local currency return was -1.1%. Latin America continued its outperformance while value and small caps outperformed among styles. Unsurprisingly, EEMEA saw the largest drawdown given it was at the epicenter of the Russia-Ukraine crisis. While macro developments (rising inflation and higher yields) supported Value overgrowth, retail capitulation remained a theme for the second successive month with investors exiting the darlings of 2021 yet again.

- **Fixed income:** PGAA's Global Policy Rate indicator rose to 1.58%, largely driven by Russia's rate hike that took policy rate from 8.5% to 20%. PGAA's Global Sovereign 10-yr Yield indicator ended 12bps higher at **2.82%** (22 out of the 29 countries we track had higher yields). Yield curves were stable, with the global 2-10yr spread at 57bps. US high yield and investment grade spreads widened 16bps and 17bps respectively. EM high yield spread outperformed, narrowing 21bps while Euro HY underperformed with a widening of 78bps.

- **Currencies:** Despite all the volatility induced by geopolitical risks, the US$ actually depreciated 0.6% against its broad trade-weighted basket, with almost half the currencies appreciating against it. Latin American currencies continued to strengthen even as the Russian Ruble came under significant pressure, with the US$ gaining 36% against it. Our real effective exchange rate-based currency valuation models suggest that the US$ remains overvalued.

- **Commodities:** The GS commodity index jumped 9%. The rally was broad-based but Agricultural commodities performed the best, rising 10% on fears of reduced supplies from Ukraine/Russia due to the conflict. Oil prices got a boost after the Russian invasion, with brent oil ending at $101/barrel. Brent oil backwardation reached its highest level since 2003 as the front end rallied due to fears of reduced supplies due to the conflict.

II. Looking Ahead

1. A growth taper

The global economy continues to grow but risks are rising as financial conditions tighten, trade gets impacted adversely by the military conflict between Ukraine and Russia, and the inflation cycle extends to dent consumers pockets. While pent-up demand by global consumers remains, and wealth effects remain supportive, they will be able to carry the baton only some more distance. Therefore, risks are that growth, which remains above trend currently, moves back to trend sooner than our earlier expectation. On the upside, however, companies are still building inventories that are still low relative to sales, and Chinese policy easing is helping growth in China.

2. Inflation

Inflation remains the most important metric for policymakers and us. It is the reason that the U.S. Fed has shifted its monetary policy focus from stimulating inflation under its Average Inflation Targeting Framework to "controlling" it now to restore its credibility. It is unlikely they will back off unless inflation expectations get back in the 2-2.25% range, even if growth slows more than expected. While our leading indicator continues to predict a tail-off in inflation this year, it remains hostage to commodity prices which are getting a major boost from the Ukraine-Russia conflict.

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 control in several developed countries. China, though, remains an exception for now, as inflation is subdued and growth weak, which forced the People's Bank of China to shift to a supportive stance. Global financial conditions have already tightened this year and will tighten some more, taking them into neutral territory for the first time since 2018.

4. Valuations

- **Global risk premiums widened a tad in February 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 sustain interest in risk assets.
- **Equity** valuations cheapened in February but remained rich barring parts of EM and Europe. Slowing growth and tightening financial conditions present headwinds, too.
- **Corporate spreads** widened towards fair value as risk-off gripped markets. However, given strong nominal growth, and the strong health of the corporate sector, 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, geo-political risks could cause a flight towards safety.

5. **Sentiments & technical indicators**

The continued market correction in February kept the technical positioning in slightly bearish territory. Retail investor expectations were in oversold territory at -30, their lowest in 10 years. Risk-parity and volatility targeting strategies are being forced to reduce risks. Short-term momentum scores are flashing risk-off barring commodities. Hedging demand remained strong, with U.S. Equity Put/Call ratio at 0.96.

6. **Summarizing our thoughts on risk assets:** While geopolitical risks tend to have a short life in terms of market impact, this episode is complicated, can have a fat tail, and can cause commodity prices to spiral to levels that start hitting consumption meaningfully. That makes us downgrade our asset allocation stance towards **Neutral** in the short-term. Our checklist of various factors stacks up as:
    a. **Return-to-Work strategies –** Omicron seems to have peaked in many parts of the world. Vaccinations continue to rise. The world is learning to live with the virus. All considered, we keep this factor at **"neutral".**
    b. **Growth -** Both macro and bottom-up growth environments are facing a challenge from geopolitical risks which is likely to prolong the inflation cycle, unless demand slows enough to balance tight supplies. While consumers still retain savings buffers, they are shrinking, especially for those at lower income buckets. Tightening financial conditions present another risk. Therefore, we downgrade the growth factor to **"neutral".**
    c. **Monetary policy** – Policy rates are rising and excess liquidity will be withdrawn gradually as focus shifts to inflation control. China, however, changed its monetary policy stance to supportive recently. Europe and Japan aren't ready to start tightening yet. Overall, we retain this factor at "**neutral**".
    d. **Fiscal policy** – While we don't expect any large spending packages from governments globally, there is a chance that rising energy costs will be subsidized by European Governments and several emerging economies. China is likely to loosen fiscal policy to support growth, too. Overall, we keep this factor as **"mildly positive"**.
    e. **Valuations –** Risk premiums are low, and the possibility of real rates rising fast remains. We keep this factor at **"negative",** though less so than in 2021.
    f. **Technical factors –** Positioning has turned slightly bearish but not to the extent that it causes a technical rebound in broad risk assets. We keep this factor at "**neutral"** for now but a futher drawdown may cause us to upgrade it to "mildly positive".

7. **Key risks:** The key risks to our mild pro-risk stance are:
    - Geopolitical risks worsen, presenting a fat tail in the Russia-Ukraine conflict.
    - Inflation gets fresh legs from higher commodity prices, tying the hands of Central banks and leading to to a stagflationary environment.
    - New variants dent vaccine efficacies, causing governments to reimpose restrictions.
    - Policymakers take active steps to control spiraling home prices to send a social message.
    - 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.

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.

Indices are unmanaged and do not consider fees, expenses and transaction costs are not available for direct investment. 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.