Multi-Asset perspectives

Courtesy of Principal Global Investors

April 2022

Highlights

Macro

- **COVID generally** took a backseat in a month that continued to be dominated by headlines on the ongoing Russian invasion of Ukraine (no breakthroughs yet), and on the path of global monetary policy (distinctly hawkish). **In April, while global COVID infections** rose 5% to **514 million,** the 7-day average of new cases dropped to 609k, the lowest since early December 2021. While most countries saw visible declines, the rising trend in China was met with lockdowns in key cities like Shanghai and Beijing as China stuck to its zero-tolerance policy. **Global fatalities** slid further to 1.21% from 1.26%. **Our Global Stringency Index** remained range bound at 56 (100=most stringent) with Europe taking further steps to get back to the pre-COVID way of life. Regionally, Europe remained the least stringent at 30 vs Asia at 74, driven largely by China's score of 75. **Global vaccinations** increased to 11.6bn (150 per 100 population), with the median country in our coverage at 215 doses per 100.
- **Economic activity** stayed on course to normalize lower. Our provisional global Manufacturing PMI eased further to 53.0, driven by a decline in both DM (55.2) and EM PMIs (49.3). Our Global Industrial Production Leading Indicator eased, too, as new orders missed but it continues to signify slightly above-trend industrial growth in the near term. Our Global Economic Surprises Index remained negative for a 5th month, with China the only bright spot. Inflation surprises remained positive, boosted by ex- U.S. data releases that were well above expectations.
- **Global financial conditions** tightened due to higher interest rates (↑), wider credit spreads (↑), lower equity returns (↓) and elevated volatility (↑). While most countries saw tighter FCI in April, US was the tightest, as it was impacted by all these factors and a strengthening US$. Global financial conditions are firmly in the neutral zone but could move into restrictive zone temporarily as central banks tighten the screws.
- **Global inflation** rose to 5.8% in Mar'2022 with 28 out of 29 countries recording higher readings. U.S. **5yr break-even** inflation eased slightly to 3.35% but remained well above the Fed target (2-2.5% range). **Our inflation leading indicator continues to predict a fade in coming months, but levels will remain well above policy targets.** Geopolitical developments (the Russia-Ukraine war which is boosting commodity prices further) and China lockdowns could lead to intensification of supply bottlenecks, delaying the normalization.
- **Our cross-asset volatility indicato**r jumped as equity, fixed income and currency volatilities rose in a correlated fashion. Higher volatility remains a key source of frustration for leveraged, risk-parity and volatility targeting strategies.

Bottom-up

- Earnings revisions have rolled over. MSCI AC World's **expected EPS growth** for 2022 dropped to 5%. MSCI AC World's 3-month EPS change for 2022-23 turned negative at -1%. Our preferred breadth measure, the global **3m Earnings Revisions Ratio** eased to 0.47 from 0.49 (i.e., downgrades exceeded upgrades). Sectorally, Energy and Materials continued to see upgrades, but several other sectors faced headwinds. Earnings released thus far for S&P 500 (391/499 companies have reported) showed a meagre surprise of 4%, compared to 8% in Q4'2021.
- **YTD'22 Global credit rating upgrades to total changes** was flat at 47% at the end of Apr'2022. Strong investment grade upgrade momentum (77% for US, 65% for Western Europe, and 55% for Asia Pac) was offset by weak high yield rating momentum (57% for US, 25% for Western Europe, and just 11% for Asia Pac).

Valuations

- **Global equity valuations** moved further towards fair value from expensive. DMs (mainly U.S.) remained expensive relative to EMs. Latin America remained the cheapest region globally.
- **IG and HY** spreads widened, reaching the fair value zone. The IG spread finished 9bps north of its 10-yr median, but HY (more volatile than IG) finished 27bps shy of it.
- The **U.S. 10-yr treasury** yield jumped 60bps to 2.93%, 13bps above its fair value.

Markets

- **Multi-Assets:** Our global multi-asset index dropped -6.1% in Apr'2022, bringing YTD return to a disappointing -10.3%. All assets, barring commodities, bled.
- **Global Equities** dropped -8.0% on continued geopolitical stress, China's lockdowns, continued tightening in financial conditions and rising fears that central banks may have to tighten well into restrictive territory to control inflation. Only 28% of the equity markets we track ended in the green, with a local currency median return of -2.5%. Value and minimum volatility strategies outperformed other styles. For the year thus far, Energy was the only sector with positive return (MSCI AC World Energy index returned 18% vs MSCI AC World's return of -13%). In contrast, returns from two market favorites of yesteryears i.e., Technology and Consumer Discretionary stood at -21% each.
- **Fixed income:** PGAA's Global Policy Rate indicator eased -2bps to 1.69% as the lone cut (-300bps in Russia) neutralized the impact of 8 hikes. On the other hand, PGAA's Global Sovereign 10-yr Yield indicator jumped 21bps to **3.52%** (25 out of the 29 countries we tracked saw higher yields). The 2-10 curve spread steepened 14bps to 43bps as longer dated treasuries underperformed shorter ones, with the 2-10 US spread heading back into positive territory at 22bps. US high yield and investment grade spreads widened 54bps and 19bps. Euro HY and IG widened 55bps and 21bps. EM HY spread closed 27bps wide at 658bps after a defaulted name was indexed out.
- **Currencies:** Helped by hawkish Fed and the risk-off sentiment, **the** US$ appreciated against all currencies except the Russian Ruble. DXY reached its highest level since 2002. Our real effective exchange rate-based currency valuation models continue to suggest that the US$ is overvalued.
- **Commodities:** The GS commodity index jumped 5.1% on continued supply fears. Gains in energy (7.9%) and food (5.4%) prices outweighed losses in industrial (-7.6%) and precious metals (-2.8%). Energy backwardation (especially natural gas) remained high, rewarding speculative long interest handsomely.

Looking Ahead

1. A growth taper

The global economy will slow down in coming months. High inflation is denting consumer confidence. Inventory rebuild, which is boosting growth currently will start fading. Accumulated savings balances will have reduced. Tighter financial conditions will slow activity in areas like refinancing, housing, leveraged bets into markets, and consumer spend on durables. However, China could ease to get growth back up after the hit from COVID-induced shutdowns. Prospects of additional European stimulus to fund defense spending can also provide some offset.

2. Inflation

Inflation will remain centerstage for global policymakers and market watchers. Global Central banks have few options but to keep taking steps to "control" inflation till they see visible success. U.S. 5 & 10-yr CPI Break-evens remain above policy targets, at 3.35% and 2.94% respectively. While our leading indicator continues to predict a tail-off in inflation, it remains hostage to commodity prices which present tail risks if geopolitics keeps worsening the supply side.

3. Monetary policy & global financial conditions

Globally, financial conditions should continue to tighten, taking them into neutral territory for the first time since 2018. In the U.S., at least a couple of 50bp rate hikes are very likely. Excess liquidity removal, particularly by the U.S. Fed will be a concurrent feature. Fed QT unwind details i.e., the amounts of treasury bills, bonds, and MBSs that will be allowed to run-off will be keenly watched. China, though, will keep policy accommodative given subdued inflation and weak growth.

4. Valuations

- **Global risk premiums have widened this year towards fair value zones.** Simultaneously, risk-free rates also beginning to present a positive yielding anti-fragile alternative to investors.
- **Equity** valuations have undoubtedly cheapened this year. Some parts of EM and Europe are outrightly cheap (Latin America, Korea, Malaysia, UK, and Germany) while most others are near fair value.
- **Corporate spreads** have widened into the fair value zone as the technical picture remains challenged, given the threat from a rapid increase in policy rates. Fundamentally, however, high nominal growth, composition of HY indices (a large portion in BBs) and strong balance sheets remain supportive factors, particularly for high yield.
- In **Currencies,** the US$ remains expensive but has the carry support (the 2-yr swap spread between USD and EUR has widened to 208bps in favor of US$) and retains its status as a strong safe-haven asset during periods of uncertainty.

5. Sentiments & technical indicators

The technical picture has flipped from overbought to oversold. Most equity indices are flashing red on at least one of the two short-term price momentum signals we follow. Retail investor expectations got back into deep oversold territory at -43. Risk-parity and volatility targeting strategies are carrying much less risk than at the start of the year. Hedging has picked up with U.S. Equity Put/Call ratio reaching an all-time high of 1.33 vs a long-run median of 0.97.

6. **Summarizing our thoughts on risk assets:**

While geopolitical risks tend to have a short shelf-life from a market impact perspective, the ongoing Russia-Ukraine situation is having a more prolonged economic impact through the commodity price/inflation route, which has necessitated aggressive monetary policy tightening by global central banks. While valuations are beginning to cheapen, we retain our asset allocation stance at **Neutral** in the short-term. Our checklist of various factors stacks up as:

   a. **Return-to-work –** Omicron has 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 -** Geopolitical risks are prolonging the inflation cycle which could present challenges for companies when demand starts waning as financial conditions tighten. Inflation is eating into consumer savings buffers. The tailwind from positive wealth effects looks set to wane in coming months. 1Q'2022 earnings releases show that while surprises remain positive, their magnitude has halved in the US (from 8% for 4Q'2021 to 4% thus far for 1Q'2022). Overall, the path for growth appears lower in the months ahead. We retain the factor at **"neutral"** currently but could flip to "negative" should the deceleration be more rapid than expected.
   c. **Monetary policy** – Policy rates are rising, and excess liquidity is being withdrawn as focus shifts to inflation control. The U.S. Fed has indicated readiness to move in 50bp increments and announced Quantitative Tightening. While China is running a supportive monetary policy, they are unlikely to stimulate aggressively due to fears of furthering the asset bubble in housing. Overall, we retain this factor at "**neutral**" as financial conditions are still in neutral territory, but risks tilted to the downside.
   d. **Fiscal policy** – While we don't expect any large spending packages, rising energy costs are bringing subsidies back into the fore (Germany has already taken the lead in subsidizing energy costs while Italy is imposing windfall taxes on energy producers to fund consumer subsidies). Higher defense spending in the Euro-Area could add to fiscal spending targets in the bloc. China could loosen fiscal policy to support growth, too. Overall, we keep this factor as **"mildly positive"**.
   e. **Valuations –** Risk premiums are wider since the start of the year. We keep this factor at **"negative"** for now, but the risk is tilted to the upside i.e., an upgrade to "Neutral" as risk premiums move into fair value zone from expensive.
   f. Technical factors – Positioning signals are bearish, prompting us to upgrade this contrarian factor to "positive" from "**neutral**".

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 continues to be well above policy goals, leading central banks to keep tightening policy despite weakening growth.
   - New variants of the virus 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.

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