Multi-Asset perspectives

Courtesy of Principal Global Investors

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Highlights

Macro

- **COVID** news dominated in China where lockdowns in pursuit of their zero-COVID policy created growth headwinds. Elsewhere, the world adjusted further to a "life with COVID". **While global COVID infections** rose 3% to **529 million,** the 7-day average of new cases dropped to 420k, just 12% of its peak reached in mid-Jan 22. The **Global Fatality rate** slid to 1.19%. **Our Global Stringency Index** eased to its lowest since Mar 2020, reaching 48 (100=most stringent) as most regions barring China eased restrictions. Europe remained the least stringent at 22, US at 39 (its lowest since the outbreak) and Asia at 74 where China was the tightest at 79.
- **Economic activity** stayed on course to normalize lower. Our Global Industrial Production Leading Indicator (3-month average) eased, pushing industrial growth towards its long-term trend. Our Global Economic Surprises Index remained slightly negative for a 6th month. However, our provisional global Manufacturing PMI ticked up, driven by a surprise uptick in US (56.1 from 55.4) and a recovery in Chinese PMI (49.6 from 47.4) as the economy limped back towards normalcy as COVID lockdowns were gradually eased in key cities.
- **Global financial conditions** stabilized after several months of tightening. Higher rates and lower monetary growth tightened conditions but tighter credit spreads and less adverse equity momentum & volatility provided equal offsets. Regionally, conditions eased in China and core Europe but tightened in India and Korea. Financial conditions are likely to move into restrictive territory as central banks keep tightening the screws to control inflation.
- **Global inflation** rose to 6.2% in Apr 2022 though the breadth weakened, with 18 out of 29 countries recording higher readings vs 28 the month prior. However, expectations-based inflation measures softened. **5yr break-even** inflation eased to 2.96% from 3.35% in the US, though remained above the Fed target (2-2.5% range). 10-yr Inflation swaps in Germany eased 32bps to 3.14%. **Our inflation leading indicator continues to predict a fade in realized inflation in coming months, but levels will remain well above policy targets.** Worsening geopolitical developments and China lockdowns which intensify supply bottlenecks present upside risks.
- **Our cross-asset implied volatility indicato**r eased from mid-month highs to end the month slightly lower but remained above its historical average. The easing in volatility was across the board. Higher volatility remains a key source of frustration for leveraged, risk-parity and volatility targeting strategies.

Bottom-up

- Earnings revisions were mixed. MSCI AC World's **expected EPS growth** for 2022 ticked up to 6% as the 1Q 2022 earnings season delivered positive surprises in aggregate. Energy and Materials led upgrades, while other sectors faced headwinds. MSCI AC World's 3-month EPS change for 2022-23 remained negative at -1%. Our preferred breadth measure, the global **3m Earnings Revisions Ratio** eased to 0.46 from 0.47 (i.e., downgrades just exceeded upgrades).
- **YTD '22 Global credit rating upgrades to total changes** were at 47% at the end of May 2022. Strong IG upgrade momentum (71% for US, 64% for Western Europe, and 58% for Asia Pac) was dampened by continued weakness in HY rating momentum (54% for US, 29% for Western Europe, and just 13% for Asia Pac). Based on historical evidence, IG rating momentum could be near its peak.

Valuations

- **Global equity valuations** nudged closer to fair value. Regionally, US remained the most expensive, and LatAm the cheapest.
- **IG and HY** spreads were relatively unchanged and stayed in the fair value zone. The IG spread finished 6bps north of its 10-yr median (116bps), but HY finished 27bps shy of it.
- The **U.S. 10-yr treasury** yield, at 2.84% was 72bps above its 10-yr median, putting it in the cheap camp, though our Fundamental fair value model shows it at fair value (2.9%).

Markets

- **Multi-Assets:** Our global multi-asset index ended with a modest 0.4% gain in May '22 (YTD'22 -10%) with help from commodities.
- **Global Equities** recovered from a torrid start to close the month broadly unchanged. Continued geopolitical stress, China's lockdowns, tightening financial conditions and inflation eating into consumer spending pockets dominated sentiment. Rebalancing and value buying amidst a market positioned lightly explained the 5-8% rally witnessed in the second half of the month. Half the markets ended in the green, with a local currency median return of 0% (YTD'22 median return of -6%). Value outperformed. Energy was the best performing sector, expanding its lead over IT to 56% (32% vs -22%) for the year globally (MSCI AC World). The numbers were starker for US where its lead swelled to 76% (55% vs -21%).
- **Fixed income:** PGAA's Global Policy Rate indicator gained 10bps to 1.79% as there were 17 hikes during the month. PGAA's Global Sovereign 10-yr Yield indicator was unchanged at 3.52% though 19/29 countries ended with higher yields as US and Chinese yields eased -9bps and -4bps respectively. The 2-10 curve spread was flat at 44bps, with the US curve steepening 7bps to 29bps. US high yield spread widened 27bps, but Investment grade narrowed 5bps.
- **Currencies:** A hawkish tilt in the monetary policy stance in ex-US developed markets stopped the US$ in its tracks. Commodity currencies like CAD, AUD, and Latin American currencies performed well, too. Consequently, the US$ ended on the weaker side against 67% of the currencies we track it against. Our real effective exchange rate-based currency valuation models show that the US$ remains overvalued. The Japanese Yen is the cheapest.
- **Commodities:** The GS commodity index continued its stellar rise by gaining 4% on persistent supply fears. Gains in energy (8%) compensated for losses in food (-2%), industrial metals (-6%) and precious metals (-4%). Energy backwardation remained high, rewarding speculative long interest handsomely.

Looking Ahead

1. A growth taper

The global economy will slow down in coming months. Supply side bottlenecks persist. High inflation is denting consumer confidence. Inventory rebuild, which is boosting growth currently will start fading in the 2nd half of the year. Accumulated real savings balances will have reduced too, particularly for low-income earners. Tighter financial conditions will slow activity in areas like refinancing, housing, and possibly consumer spending on durables. However, China is stepping up easing to reduce the hits from COVID-induced lockdowns. Prospects of additional European stimulus to fund defense spending should also provide some offset.

2. Inflation

Inflation surprise remained positive in May 2022, boosted by very large beats in Europe though US releases just trailed expectations. Inflation will remain centerstage for global policymakers and market watchers. Global Central banks have few options but to keep fighting inflation till they reach neutral policy rates. US 5 & 10-yr CPI Break-evens remain above policy targets but are off their highs. While our leading indicator continues to predict a tail-off in inflation, it remains hostage to commodity prices and supply bottlenecks.

3. Monetary policy & global financial conditions

Globally, financial conditions have tightened into neutral territory from extremely easy a few months back. US policy rate could exceed 2.5% by 4Q 2022. Excess liquidity removal through quantitative tightening adds uncertainty, though 2022 looks secure from a Fed withdrawal perspective as US borrowings will be much lower than 2021, given a shrinking budget deficit ($1.2 trillion rolling 12 months at the end of Apr 2022 vs $3.6 trillion at the end of Apr 2021). ECB will start its hiking cycle shortly. Asian Central banks are beginning to hike too; China, though, will keep policy accommodative. Latin America is approaching the end of this tightening cycle.

4. Valuations

- **Global risk premiums have widened this year towards fair value zones.** Simultaneously, risk-free rates have also begun 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, Germany) while several others are near fair value. US markets remain expensive in a relative sense though their absolute valuations are more reasonable than at the start of the year.
- **Corporate spreads** have widened into fair value zone. The technical picture, however, remains challenging, given the threat from rapidly rising policy rates and high market volatility. Fundamentally, however, high nominal growth, the composition of HY indices (a large portion in BBs) and well-funded balance sheets provide support.
- In **Currencies,** the US$ remains expensive but remains the best anti-fragile absorbent of investor de-risking. Carry differentials, that have swung in favor of USD since the start of the year, could start fading as other central banks jack policy rates, which could provide support to non-USD currencies.

5. Sentiments & technical indicators

The technical picture remains light. Overbought price momentum signals in risky assets barring commodities have clearly rolled over. Retail investor expectations remain in deep oversold territory. Hedge funds, risk-parity and volatility targeting strategies have shed risk since the start of the year.

6. **Summarizing our thoughts on risk assets:** The ongoing Russia-Ukraine situation shows no signs of a truce and continues to impact the global economy through higher oil, gas, and food prices. That has forced policy makers into a faster pace of tightening than they would have liked. On the positive side, valuations are beginning to cheapen, and positioning has lightened. Nominal growth remains strong but will normalize lower. All considered, we retain our asset allocation stance at **Neutral,** cognizant that valuations could undershoot as market adjusts to the new reality. Our checklist of various factors stacks up as:
    a. **Return-to-Work –** The world is learning to live with COVID even though China's zero-COVID approach presents a wild card. We keep this factor at **"neutral".**
    b. **Growth -** Geopolitical risks have prolonged the inflation cycle which is likely to present challenges for both consumers (lower real incomes) and producers (tighter margins if demand normalizes lower). Tailwinds from positive wealth effects will wane in coming months, too, given the hit to global equities, where popular stocks are down far more than what headline indices suggest. 1Q 2022 earnings releases show that while surprises remain positive, their magnitude is lower. Overall, the path for growth is skewed to the downside 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 globally to control inflation. While China's easing stance provides an offset, they are unlikely to stimulate aggressively due to fears of furthering the housing bubble. Overall, we retain this factor at "**neutral**" as financial conditions are still in neutral territory, but risks remain 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, UK, Italy). Higher defense spending by US to support Ukraine and in the Euro-Area could reduce some of the fiscal drag from reduced budget deficits. China could loosen fiscal policy to support growth, too. Overall, we keep this factor as **"mildly positive"**.
    e. **Valuations –** Risk premiums have widened since the start of the year. We move this factor to "**neutral**" from **"negative",** recognizing the distance travelled.
    f. **Technical factors –** Positioning signals are generally bearish, prompting us to keep this contrarian factor at "**neutral**".

7. **Key risks:** The key risks to our stance are:
    - Geopolitical risks worsen, presenting a fat tail in the Russia-Ukraine conflict.
    - Inflation continues to stay well above policy goals and proves stickier than we expect due to supply side issues.
    - 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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