Multi-Asset perspectives

Courtesy of Principal Global Investors

July 2022

Highlights

Macro

- As the world is learning to “live with COVID”, virus news is beginning to lose significance for markets. The one exception is China, whose zero-COVID policy results in intensified testing and lockdowns when cases spike up. Our **Global Stringency Index** is at its lowest since Mar’2020 at 45 (100=most stringent). Europe is the least stringent at 18, U.S. is at 39 (its lowest since the outbreak) and Asia at 72, where China was the highest at 79.
- **Economic activity** continued to normalize lower as we have been expecting. Weaker new orders in some countries inched our Global Industrial Production leading indicator (52.4) closer to the breakeven level of 50. Our Global Economic Surprises Index remained slightly negative, as it has been since Nov’21 with China the only region to record a positive surprise. Our provisional Global Manufacturing PMI softened to 51.3, driven by deterioration in US, China, and Europe. Breadth weakened, too. Only 15% of the countries saw higher sequential PMIs. 38% of the countries are now below 50 (contraction) versus 15% the month prior.
- **Global financial conditions** eased after months of tightening. Spreads (tighter), equity momentum (better) & volatility (lower) eased financial conditions. However, higher policy rates (↑33bps including another hike of 75bps by the Fed) nullified the effect from lower bond yields (↓28bps). Real yields dived as nominal yields declined while inflation expectations increased.
- **Global inflation** rose to 6.8% in June’2022 as did expectations-based inflation measures. 25 of the 29 countries we track printed higher inflation readings. 10-yr break-even inflation implied by US TIPS rose 21bps to 2.81% while 5-yr break-even rose to 2.81%, staying above Fed’s target (2-2.5%).
- **Our cross-asset implied volatility indicator** came off its recent peak but remained above its long-term average at 85 vs 74. Equity, fixed income and crude volatilities were down significantly but Fx volatility remained relatively high. Higher volatility is a source of frustration for leveraged, risk-parity and volatility targeting strategies.

Bottom-up

- Global bottom-up earnings revisions were mixed. MSCI AC World’s **expected EPS growth** for 2022-23 was stable around 6%. Energy continued to see large upgrades. The 3-month change in EPS recovered to 0% from -2% though S&P 500’s number fell below zero for the first time after the pandemic. Our preferred breadth measure, the global **3m Earnings Revisions Ratio** slowed to 0.45 (i.e., downgrades just exceeded upgrades).
- **YTD’22 Global credit rating upgrades to total changes** were at 49% at the end of July’22. IG upgrade momentum remained very strong (80% for U.S., 67% for Western Europe, and 58% for Asia Pac) while HY momentum remained weak, particularly for ex-US issuers (51% for U.S., 32% for Western Europe, and just 15% for Asia Pac). Based on historical patterns, global IG rating momentum (70% upgrade ratio) could be near its peak.

Valuations

- **Global equity valuations moved back into expensive zone** after the robust appreciation in prices in July. MSCI ACWI was cheaper than current levels 86% of the time in history, compared with 58% the month prior. Regionally, U.S. remained the most expensive, and LatAm the cheapest.
- **U.S. IG and HY** spreads narrowed 9bps and 100bps respectively to 134bps and 469bps respectively. Both ended in fair value zone, with IG 18bps north of its 10-yr median and HY 64bps.
- The **U.S. 10-yr treasury** yield, at 2.65%, was 52bps above its 10-yr median, though the drop in July took it to the expensive side, given that macro variables that go into our FV model (PMIs, inflation) didn’t change much.

Markets

- **Multi-Assets:** Our global multi-asset index gained 4.5% in July'22 as all asset classes barring commodities clocked positive returns. The YTD'22 drawdown narrowed to -11.9% from -15.7%.
- **Global Equities** recovered sharply from deeply oversold conditions as weakening growth raised hopes for a dovish tilt in monetary policy, that led real 10-yr UST yield to drop -36bps. 34 out of the 40 markets we track ended in the green, with a median local currency return of 4.5% (YTD'22 median return of -9.7%). Consumer discretionary and IT led the rebound. Growth and quality factors outperformed after lagging all this year.
- **Fixed income:** PGAA's Global Policy Rate indicator gained 33bps to 2.45% with 16 hikes during the month. However, PGAA's Global Sovereign 10-yr Yield indicator declined -28bps to 3.47% as 27/29 countries ended with lower yields. The 2-10 curve spread flattened -17bps to 16bps, with the U.S. curve inverting to -24bps. 2-5s at -21bps also inverted in the U.S. as bond markets anticipate rate cuts aggregating 100bps between the end of 2022 and 2024 in response to recessionary conditions. Credit Spreads were mixed. U.S. and European spreads came in for both IG and HY. EM IG, Asia IG and Asia HY spreads widened as Chinese property names continued to trade at stressed levels.
- **Currencies:** Recession fears boosted DXY to an intra-month high of 108.5, before recovery in risk sentiment pushed it down to 105.9. Still, 19/30 currencies we track weakened further the US$. Among majors, EUR depreciated the most due to continued stress from the Russia-Ukraine conflict. The greenback also jumped 15% against the Ruble which reduced its YTD'22 drop to -17% from -28%.
- **Commodities:** The GS commodity index eased another -2.3% as investors pulled money out of commodity funds, given the impending growth slowdown. While it pared its YTD'22 gain to 23.4%, it remained the best performing asset class by a wide margin. Agriculture (-3.7%) was the worst performer followed by energy (-2.8%). Movements in industrial metals (0.4%) and precious metals (-1.4%) were more muted. Backwardation remained high in oil, suggesting persistence of tight supplies.

Key risks

- Geopolitical risks worsen, presenting fat tails, both in the ongoing Russia-Ukraine conflict, and developments in Taiwan where House Speaker Pelosi's visit is stirring up tensions.
- Inflation continues to stay well above policy goals, proving stickier and leaving policymakers no choice but to hit growth hard to bring it back under control.
- 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 try to flatten the income curve.

Looking Ahead

1. **COVID & Restrictions** **Neutral**

   The world has learnt to live with COVID though China's zero-COVID approach adds volatility. We retain this factor at **"neutral".**

2. **Growth** **Negative**

   All indicators suggest that the global economy is slowing down. High inflation has pushed real consumer spending into the red. Inventory rebuild is becoming a headwind from a tailwind. Low-income earners are drawing down accumulated real savings at a rapid clip to support consumption. Tighter financial conditions are curbing refinancing and housing activities. While China's response to get growth back up is a positive, it is unlikely to take the shape of a mammoth spending package. Europe continues to struggle as prospects of energy rationing become real.

3. Inflation Negative

Inflation surprise turned positive again in Jun’2022 on higher food, energy, and accommodation costs. Inflation remains centerstage and unless Central banks see a sustained drop in inflation readings towards policy targets, they are unlikely to take their feet completely off the monetary tightening pedal. While our I**nflation leading indicator** continues to predict a fade in inflation in coming months, that path has been muddied by geopolitical developments (supply shortages), disruptions from COVID-induced lockdowns in China and the pricing power that companies seem to have acquired since the pandemic.

4. Global financial conditions Neutral

Globally, financial conditions have tightened and are unlikely to ease unless inflation starts rolling over meaningfully. U.S. policy rate is likely to be around 3.5% by 4Q’2022 (100-125bps above its long-run neutral). Excess liquidity removal through quantitative tightening will add uncertainty as we move into 2023. 2022, however, looks secure as U.S. borrowings will be much lower due to a shrinking budget deficit ($1.05 trillion over the rolling 12-month period ending June’22, -$1.5 trillion lower than the number as of June’21, and the lowest since Nov’2019).

5. Valuations Neutral

- **Risk-free rates:** Higher risk-free rates are presenting meaningful positive yielding anti-fragile alternatives.
- **Equity Valuations** have cheapened this year though the equity rally in July pushed U.S. equity valuations back into the expensive zone. Our screen still has several green spots (Germany, UK, all Latin America, Korea, HK, Taiwan, Malaysia & Indonesia) with several others in the fair value zone. U.S. large cap and Growth remain expensive even as their absolute valuations are more reasonable than at the start of the year.
- **Corporate spreads** are in fair value zone, still some distance from the screaming cheap zone. Rising policy rates and high market volatility could cheapen them further.
- In **Currencies,** the U.S.$ remains expensive but remains the best anti-fragile absorbent of investor de-risking. A sustained decline in the value of the $ is unlikely till clarity emerges on inflation, growth, and monetary policy paths.

6. Technicals Neutral from Positive

While the technical picture remains light, the risk rally in July moved all **oversold** assets to **neutral** on indicators like Bollinger bands/RSI. The percentage of global equity markets above their 50-day moving average jumped to 75%, though it was just 20% on 200-day moving average. % of NYSE stocks above their 200-day moving average rose to 29% but remained well below its 10-yr median of 55%. Retail investor expectations remained in negative territory. Hedge funds, risk-parity and volatility targeting strategies have shed risk noticeably since the start of the year.

7. Overall Asset allocation Neutral

Despite expectations of weaker growth, we remain neutral in our stance towards risk assets, given that a shallow recession has already been priced in by markets, and risk premiums reflect the economic reality better than they did at the start of the year. While the ongoing Russia-Ukraine situation shows continues to impact natural gas supplies to Europe, attempts to restart food exports from Ukraine have reduced tail risks marginally. However, US-China relationship remains strained and adverse developments in Taiwan can bring added volatility. A sustained improvement in inflation outlook and/or a further expansion of risk premiums would most likely cause us to turn more positive on risk assets.

Risk considerations
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