Multi-Asset perspectives

Courtesy of Principal Global Investors

August 2022

Highlights

Macro

- Most of the world has adapted to living with COVID-19 without letting it upset the normal way of living. China's zero-COVID tolerance policy through localized lockdowns and mass testing remains an aberration. Economically too, the impacts from new cases are waning with supply chains significantly less disturbed than before.
- **Economic activity** continued to normalize lower as we have been expecting. Weaker new orders in some countries inched our Global Industrial Production leading indicator (51.7) closer to its no-expansion level of 50. Our provisional Global Manufacturing PMI softened to 51.0, driven by deterioration in Japan and Europe. Breadth remained weak as only 27% of the countries saw higher sequential PMIs. Only 19% of the countries' PMIs are higher than one year ago. Our Global Economic Surprises Index, however, turned slightly positive as releases were just ahead of lowered expectations.
- **Global financial conditions** tightened to their worst since Mar'2020 as the July relief rally ran out of steam. All subcomponents were tighter, with rates the main contributor. U.S. FCI tightened the most regionally, driven by dollar strength and higher rates as Fed speakers remained hawkish.
- **Global inflation** showed signs of peaking at 6.7% in July'2022 (3-month change eased to an annualized pace of just 1.5%). 17 of the 29 countries we track printed higher readings, lower than last month's 25. In the U.S., PCE inflation dropped from 6.8%yoy to 6.3%yoy. 10-yr break-even inflation implied by U.S. TIPS eased -7bps to 2.48% while 5-yr break-even eased to 2.64%.
- **Our cross-asset implied volatility indicator** inched up to 89, staying above its long-term average of 74. Slight drops in currency and crude volatilities were offset by increases in equity and bond volatilities. Higher volatility remains 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 eased to around 5%. The 3-month change in EPS dropped to -3%. While Energy continued to see upgrades, other sectors were revised lower. Our preferred breadth measure, the global **3m Earnings Revisions Ratio** eased to 0.44 (i.e., downgrades exceeded upgrades marginally). U.S. weakened to 0.39 while DM-ex-US and LatAm stood out at 0.51 and 0.55 respectively.
- **YTD'22 Global credit rating upgrades to total changes** slowed to 48% at the end of August'22. While IG upgrade momentum remained strong at 67%, it was lower than previous month's 71%. HY remained weak, at 37% (38% the month prior).

Valuations

- **Global equity valuations moved towards fair value (from expensive) after the Aug'2022 drawdown in prices.** Though MSCI ACWI has been cheaper than current levels 73% of the time in history, the number was 86% the month prior. Regionally, U.S., India, Singapore, and Thailand were expensive, while LatAm, Korea and Germany were the cheapest.
- **U.S. IG** spread narrowed 4bps to 130bps, but **U.S. HY** widened 15bps to 484bps. Based on our fundamental valuation models, each ended slightly wide of its fair value. However, each was well inside the value suggested by our market-based models, implying that the markets expect far more deterioration in fundamentals down the line.
- The **U.S. 10-yr treasury** yield rose to 3.19%, 106bps above its 10-yr median. It remained in the fair value zone implied by our UST fair value model.

Markets

- **Multi-Assets:** Our global multi-asset index lost -3.5% in August'2022 as all asset classes ended in the red. The YTD'22 drawdown widened to -15% from -12%.
- **Global Equities** lost steam as optimism from signs of peaking inflation and earnings resiliency were offset by Powell's hawkish speech at Jackson Hole. 21 out of the 40 markets we track ended in the red. The median local currency return was -0.6% (YTD'22 median return of -12.7%). Growth and quality factors underperformed, reversing July's outperformance.
- **Fixed income:** PGAA's Global Policy Rate indicator gained 6bps to 2.51% with 14 hikes and 2 cuts. China's rate cuts, though just 10-15bps in magnitude, were symbolic of a decisive shift in its monetary stance in response to very weak growth. PGAA's Global Sovereign 10-yr Yield indicator rose 31bps to 3.79%, powered by higher DM yields (+56bps), but EM yields ended almost unchanged given drops in China, India, and Brazil. Overall, 22/29 countries ended with higher yields. The 2-10 curve spread flattened to 10bps, with the U.S. curve inverting to -30bps. 15/29 countries now have inverted curves. Credit Spreads narrowed except for Euro IG and US HY.
- **Currencies:** A hawkish Powell sent DXY to its highest in 20 years. 26/30 currencies we track weakened against the US$. Among majors, SEK depreciated the most followed by GBP and JPY. PBOC rate cuts also fueled CNY weakness with a depreciation of 2.2% against the dollar.
- **Commodities:** The GS commodity index eased another -4% as growth concerns and profit-taking caused investors to reduce commodity exposures. Energy (-6%) was the worst performer, followed by precious metals (-4%) and industrial metals (-3%). Agriculture gained 4.7% as adverse weather patterns helped outlook. Despite the drawdown, backwardation remained high in oil, suggesting persistence of tight supplies. While the index pared its YTD'22 gain to 19%, it remained the best performing asset class by a wide margin.

Key risks

- Geopolitical risks worsen, presenting fat tails, both in the ongoing Russia-Ukraine conflict, and developments in Taiwan where tensions have stirred up in recent days.
- Inflation continues to stay well above policy goals, proves stickier and leaves policymakers no choice but to hit growth hard to bring it back under control.
- The housing sector in China faces a hard landing. Worsening affordability sends global home prices sharply lower.
- New variants of the virus dent vaccine efficacies, causing governments to reimpose restrictions.
- 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 dented real consumer spending though nominal spending remains robust, driven by still-strong labor markets and higher nominal incomes. However, low-income earners are drawing down accumulated savings at a rapid clip to support consumption. Tighter financial conditions and weak affordability are curbing housing activity. While China's policy stance has turned mildly stimulative, it is limited in scope and magnitude. Europe & UK continue to struggle with astronomical energy costs. Fiscal packages that could total US$300bn to cushion the hit to consumers, energy rationing and price caps are being discussed to rescue the situation.

3. Inflation **Negative**

Inflation remains centerstage and unless Central banks see a sustained drop in inflation towards policy targets, they are unlikely to take their feet 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), and the pricing power that companies seem to have acquired since the pandemic.

4. Global financial conditions **Neutral**

Globally, financial conditions will remain tight unless inflation starts rolling over meaningfully. U.S. is clearly leading the charge in tightening conditions to bring down inflation. Its policy rate is likely to peak 175bps above its long-run neutral (2.5%). Liquidity removal through quantitative tightening will add to uncertainty as we move into 2023.

5. Valuations **Neutral**

- **Risk-free rates:** Higher risk-free rates are presenting meaningful positive yielding anti-fragile alternatives.
- **Equity Valuations** have cheapened this year. Our screen still has several green spots (Germany, Latin America, Korea, HK, Malaysia to name a few) with several others in the fair value zone. U.S. large cap and Growth remain expensive though their absolute valuations are more reasonable than at the start of the year.
- **Corporate spreads** are in fair value zone on current fundamentals but may widen some more if the stresses being priced in by certain market indicators materialize.
- In **Currencies,** the U.S.$ has become even more 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**

The technical picture remains light. Another month of drawdowns would probably cause us to move this measure to Positive from Neutral. Commodities, the most sought-after asset class, are finally seeing risk reduction by speculators (started with gold and copper and is beginning to hurt oil now). The percentage of global equity markets above their 50-day moving average was a little below its 10-yr median of 65%. However, at 20%, it remained well below its median of 74% on the 200-day moving average measure. % of NYSE stocks above their 200-day moving average was at 28%, 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 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 cross-asset risk premia are wider than at the start of the year. Among the negatives, continued tightening of financial conditions will make it hard for risk assets to rally sustainably. The Geo-political situation remains fluid too. Russia continues to play mind-games with Europe on gas supplies, which is engulfing the region into a power crisis, with electricity prices assuming stratospheric levels. Developing strains between US-China on Taiwan have the potential to add more uncertainty. On the other hand, 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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