Multi-Asset perspectives

Courtesy of Principal Global Investors

September 2022

Highlights

Macro

- Most of the world has adapted to living with **COVID-19,** without any impact from new cases. China's zero-COVID tolerance policy, however, continues to cast shadows on growth every time new cases spike up in a city.
- **Economic activity** continued to normalize lower as we have been expecting. Provisional global PMI edged lower to 50.3, driven by lower readings in developed markets. Europe came below 50 for a 2nd month while U.S. went perilously close at 50.9. Breadth remained weak. Less than one-third of the countries saw higher sequential readings; only 15% saw growth over the year. Our Global Industrial Production leading indicator (52.1) was flat but has trended lower over the past several months. Our Global Economic Surprises Index turned negative in September, with misses in both U.S. and Europe. Chinese data was in line with expectations while Japan was slightly ahead.
- **Global financial conditions** dived to their most restrictive level since the Euro crisis in 2011. All components (rates, spreads, volatility and momentum) tightened. U.S. FCI was hit particularly hard. It had its third worst month ever, declining -0.46. The 2nd worst was COVID (-0.61), the worst being GFC (-0.89). In level terms, U.S. financial conditions ended tighter than at any point since the GFC recovery.
- **Global inflation** edged lower to 6.7% in August'2022, but just 0.2% lower than the June peak. 13 of the 29 countries printed higher readings, lower than previous month's 17. In the U.S., while PCE inflation eased from 6.4%yoy to 6.2%yoy, it surprised on the upside, with expectations being for a larger decline. 10-yr break-even inflation implied by U.S. TIPS eased -33bps to 2.15% while 5-yr break-even eased to 2.16% (both within the Fed comfort zone).
- **Our cross-asset implied volatility indicator** spiked to 105.6, its highest level since the COVID outbreak, pulled up by higher equity, currency, and crude oil 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 4%. The 3-month change in EPS dropped to -4%. While Energy continued to see upgrades, other sectors continued to see chops. Our preferred breadth measure, the global **3m Earnings Revisions Ratio** was stable at 0.45 (i.e., downgrades exceeded upgrades marginally). U.S. was flat at 0.39 while Japan and LatAM stood out at 0.56 and 0.54 respectively.
- **YTD'22 Global credit rating upgrades to total changes** remained at 48% at the end of September'22. IG upgrade momentum remained strong at 68%, and HY remained weak at 37%.

Valuations

- **Global equity valuations moved into the fair value zone from expensive after the September'2022 selloff.** MSCI ACWI has been cheaper than current levels 40% of the time in history, compared to 73% the month prior. Regionally, U.S., India, Singapore, and Thailand were most expensive, while LatAm, Korea and Germany were the cheapest.
- **U.S. IG** spread widened 17bps to 147bps, and **U.S. HY** widened 68bps to 552bps, putting both in the cheap zone relative to their 10-year history. Based on our fundamental valuation models, each ended slightly wide of their fair value. However, each was still inside the value suggested by our market-based models, implying embedded deterioration in fundamentals down the line.
- The **U.S. 10-yr treasury** yield rose to 3.83%, 168bps above its 10-yr median. However, it remained in the fair value zone implied by our UST fair value model.

Markets

- **Multi-Assets:** Our global multi-asset index lost -7% in September'2022 as all asset classes ended in the red. The YTD'22 drawdown widened to -21% from -15%.
- **Global Equities** breached the June bottom as higher than expected core CPI readings in the U.S. caused the terminal rate expectations to reset significantly higher, with the U.S. Fed staying resolutely on course to douse the inflationary fire through monetary tightening. 37 out of the 40 markets we track ended in the red. The median local currency return was -6.5% (YTD'22 median return of -18.2%). Momentum and minimum volatility outperformed, while long-duration growth proxies underperformed.
- **Fixed income:** PGAA's Global Policy Rate indicator gained 43bps to 2.94% with 22 hikes and 2 cuts. The U.S. Fed hiked another 75bps, which pushed market expectations of the terminal Fed rate to 4.5%. PGAA's Global Sovereign 10-yr Yield indicator rose 18bps to 3.84%, powered by higher DM yields (+32bps), but EM yields ended almost unchanged. Overall, 23/29 countries ended with higher yields. The 2-10 curve spread steepened to 20bps, with the U.S. curve unchanged at -28bps. 14/29 countries now have inverted curves. Credit Spreads widened across board, with Asia HY widening the most (132bps). However, Asia IG outperformed in widening just 12bps.
- **Currencies:** A hawkish Powell sent DXY to its highest in 20 years. 29/30 currencies we track weakened against the US$. Among majors, NOK depreciated the most, followed by NZD and AUD.
- **Commodities:** The GS commodity index eased another -9% as growth concerns, profit-taking and dollar strength caused investors to reduce commodity exposures. Energy (-12%) was the worst performer, followed by industrial metals (-6%) and precious metals (-2%). Agriculture was flat. Despite the drawdown, backwardation remained high in oil, suggesting persistence of tight supplies. While the index pared its YTD'22 gain to 8.3%, it remained the best performing asset class by a wide margin. Talks of an output cut by OPEC in coming weeks may support oil prices.

Key risks faced by markets

- Inflation control requires a deeper recession than that implied by markets.
- The housing sector in China faces a hard landing. Worsened affordability sends global home prices sharply lower.
- Geopolitical risks worsen, presenting fat tails, both in the ongoing Russia-Ukraine conflict, and in Taiwan.
- 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**

We retain this factor at **"neutral".** While China's zero-COVID approach keeps adding volatility, we expect their policy to get more aligned with the rest of the world after the Party Congress in November this year.

2. Growth **Negative**

Macro indicators confirm that the global economy is slowing down. High inflation has dented real consumer spending, particularly for low-income earners, though nominal spending remains robust driven by still-strong labor markets and higher nominal incomes. Significantly tighter financial conditions and declining affordability are dragging housing activity lower. While China's policy stance has turned mildly stimulative, it is limited in scope and magnitude. Europe and the UK continue to struggle with astronomical energy costs but are adding fiscal stimulus to reduce the impact on both consumers and businesses. Fiscal packages totaling US$400bn have already been announced by them.

3. Inflation **Negative**

Inflation remains centerstage and unless Central banks see a sustained drop in inflation towards policy targets, they are unlikely to relent. While several leading components (freight rates, supply bottlenecks, commodity prices) are pointing towards a lower trajectory in headline inflation in coming months, confirmed by our I**nflation leading indicator**, the picture on core inflation remains challenging.

4. Global financial conditions **Negative (from Neutral)**

Globally, financial conditions will remain tight unless inflation starts rolling over decisively. U.S. financial conditions are tighter than at any other point since the GFC recovery. The U.S. policy rate is likely to peak around 4.5% and liquidity conditions will likely tighten further due to QT (quantitative tightening) in 2023. While we move this factor to **negative** from **neutral**, we recognize that a substantial part of the tightening is in the price, and therefore any good news on inflation or expected policy paths could bring an abrupt reversal in our global FCIs too.

5. Valuations **Neutral (trending towards Positive)**

- **Risk-free rates:** Higher risk-free rates are presenting meaningful positive yielding anti-fragile alternatives.
- **Equity valuations** have cheapened into fair value zone. Our screen has several green spots (Germany, Latin America, Korea) with most others in the fair value zone.
- **Corporate spreads** are in fair value zone on current fundamentals. However, they are still inside the value suggested by our volatility-based models, implying embedded deterioration in fundamentals down the line.
- In **Currencies,** the U.S.$ has become expensive, but remains the best anti-fragile absorbent of investor de-risking. If growth and inflation outlook normalize, a sustained decline in the value of the $ is possible.

6. Technicals **Positive (from Neutral)**

The technical picture lightened which causes us to move this factor to Positive from Neutral. Commodities are seeing risk reduction by speculators. Fixed income positioning is biased towards higher rates, and the U.S. $ is in overbought zone. The percentage of global equity markets above their 50-day moving average remained below its 10-yr median of 65%. However, at 25%, it remained well below its median of 74% on the 200-day moving average measure. % of NYSE stocks above their 200-day moving average shrunk to 13%, well below its 10-yr median of 55%. Retail investor expectations were deep in negative territory.

7. Overall asset allocation **Neutral**

Despite a looming recession, we remain neutral in our stance towards risk assets as cross-asset risk premia are much wider than at the start of the year. Among the negatives, failure to get inflation back into control could lead to further tightening of financial conditions, which would worsen the recessionary impulse. The geopolitical situation remains fluid too, with Russia continuing to play mind-games with Europe on gas supplies, pushing the region into a power crisis. A sustained improvement in inflation outlook and/or a further expansion of risk premiums would most likely cause us to turn outrightly positive on risk assets.

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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