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Multi-Asset perspectives

Courtesy of Principal Global Investors

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Highlights

Macro

- **COVID-19** is fading away from memory except China whose zero-tolerance policy continues to cause economic volatility. A change of tack is unlikely anytime soon, despite the leadership reshuffle at the recently concluded Party Congress, which saw President Xi strengthen his position even more than before.
- **Economic activity** continued to normalize lower as expected. Provisional global PMI touched contractionary territory at 49.5. Both DM PMI (49.1) and EM PMI (49.8) were weak. 58% of the countries entered contractionary territory. Only 23% saw higher sequential readings, and only 4% saw growth over 12 months. Our Leading Regime Indicator (51.8) got closer to the contractionary level of 50. Our Global Economic Surprises Index was flat, with small +ve surprises in Japan and China washed out by misses in U.S. and Europe.
- **Global financial conditions** remained at their most restrictive level since the Euro crisis in 2011. Slight improvements in credit and volatility components were washed away by higher rates and weaker monetary growth. In level terms, U.S. financial conditions remained at their tightest since the GFC recovery.
- **Global inflation** edged up to 6.9% in Sept 2022, revisiting its June 2022 peak. 16 of the 29 countries printed higher readings. In the U.S., while PCE inflation was flat at 6.2% yoy, core PCE ticked up 2/10th to 5.1% yoy. 10-yr break-even inflation implied by U.S. TIPS jumped 36bps to 2.51% while 5-yr break-even jumped to 2.66% (both above the Fed comfort zone). Global Inflation surprise was positive with a hefty contribution from Europe.
- **Our cross-asset implied volatility indicator** eased -9.5% as equity markets recovered and oil price volatility eased. However, the measure remained 30% above its long-term average, indicating asset markets remain anxious about both monetary policy and economic outcomes.

Bottom-up

- Global bottom-up earnings revisions were soft. MSCI AC World's **expected EPS growth** for 2022-23 eased to 3%. The 3-month change in EPS remained negative at -4%. Energy & Industrials continued to dominate the earnings picture. Our preferred breadth measure, the global **3m Earnings Revisions Ratio**, was a tad weaker at 0.44 (i.e., downgrades exceeded upgrades marginally). U.S. was flat at 0.39 while Japan and LatAM stood out at 0.56 and 0.53 respectively.
- **YTD '22 Global credit rating upgrades to total changes** eased to 46% (more downgrades than upgrades) as both IG upgrade momentum (63% from 68%) and HY (36% from 37%) were softer. In level terms though, IG remained very strong.

Valuations

- **Global equity valuations ended somewhat expensive relative to the month prior on recovering asset values.** MSCI ACWI was cheaper than current levels 60% of the time in history, compared to 40% the month prior. Regionally, U.S., India, Singapore, and Thailand were most expensive, while LatAm, HK, Korea, Taiwan, and Germany were the cheapest.
- **U.S. IG** spread was steady at 158bps, but **U.S. HY** narrowed -88bps to 464bps. 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, which are embedding fundamental deterioration down the line.
- The **U.S. 10-yr treasury** yield, at 4.05% was 188bps above its 10-yr median. However, it remained near its fair value (3.92%) implied by our UST fair value models.

Markets

- **Multi-Assets:** Our global multi-asset index gained 3% in October 2022, powered by equities, commodities, and credit. The YTD ’22 drawdown narrowed to -19% from -21%.
- **Global Equities** recovered in anticipation of a Fed pivot (to dovish) and technical buying due to oversold positioning in risk assets. 34 out of the 40 markets we track ended in the green with a median local currency return of 6% (YTD ’22 median return of -11%). The HK-China complex suffered as investors took bearish cues from composition of the new decision-making bodies selected at the Chinese National Congress. Momentum and Value outperformed (Momentum is beginning to be dominated by Value stocks), while long-duration growth proxies underperformed. Energy rallied further, extending its advantage over other sectors significantly.
- **Fixed income:** PGAA’s Global Policy Rate indicator gained 16bps to 3.11% with 11 hikes and a cut. PGAA’s Global Sovereign 10-yr Yield indicator rose 8bps to 4.14% with 18/29 countries seeing higher yields. The 2-10 curve spread was flat at 15bps, with the U.S. curve unchanged at -43bps. 11/29 countries had inverted curves.
- **Currencies:** Hopes of a policy pivot by the Fed checked the rampaging $ as half the currencies we track closed with gains. However, for the year, the greenback has made significant gains against all but 3 currencies (Brazilian Real, Mexican Peso and the Ruble).
- **Commodities:** The GS commodity index regained strength to chalk out a 5% gain. Energy (8%) was the best performer, supported by curtailed supplies by OPEC (they cut output by 2mbpd), the general inventory tightness (U.S. inventories of oil, gasoline, distillates, and gas remains very low by historical standards) and continued volatility from the Russia-Ukraine war. Backwardation remained high, reflecting this near-term tightness. Energy (26%) remains the best asset class this year.

Key risks faced by markets

- Inflation control requires a deeper recession than a shallow recession baked into market expectations.
- The global housing sector faces a hard landing due to worsened affordability.
- Geopolitical risks worsen, presenting fat tails, both in the ongoing Russia-Ukraine conflict, and in Taiwan where China could take steps towards unification in coming years.
- Spiking cases shut down important industrial parts of China due to its zero-COVID policy.
- 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 in 1H'2023.

2. **Growth** **Negative**
   Macro indicators confirm that the global economy will slow down even further. High inflation is denting real consumer spending, particularly for low-income earners, though nominal spending remains robust driven by still-strong labor markets and rising nominal incomes. Significantly tighter financial conditions and declining housing affordability are dragging housing activity lower. While China's policy stance has turned mildly stimulative, efforts aren't quite game-changing, given its zero-COIVD approach. Europe & UK continue to struggle with astronomical energy costs but are cushioning it through fiscal transfers, most notably in Germany.

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 (confirmed by our **Inflation leading indicator**, too), the picture on core inflation remains challenging.

4. **Global financial conditions** **Negative**
   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. Expectations for peak Fed funds rate saw a further leg up (now around 5% from 4.5% last month) after the Nov'2022 FOMC where despite acknowledgement that the Fed could move to a slower pace of hikes starting Dec'2022, Chair Powell gave strong hints that they are far from done, and that policy wasn't restrictive enough. We keep this factor at **negative** for now, recognizing that good news on inflation would cause us to consider an upgrade.

5. **Valuations** **Neutral**
   - **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 now, particularly outside the U.S.
   - **Corporate spreads** are in fair value zone on current fundamentals. However, they are still well inside the fair values suggested by our volatility-based models, which are embedding deterioration in fundamentals down the line.
   - In **Currencies**, the U.S.$ remains expensive, but is also the best anti-fragile absorbent of investor de-risking flows. If growth and inflation outlook normalize, a sustained decline in the value of the $ is likely.

6. **Technicals** **Positive**
   The technical picture remains light though not as much as it was at the end of the prior month. Speculative investors have pared their bets in risk-on assets (Commodities, Equities), are biased towards higher rates and dollar strength. The percentage of global equity markets above their 50-day moving average recovered last month to 48% from 25%, though only 25% of the markets were above their 200-day moving average. % of NYSE stocks above their 200-day moving average expanded to 34% from 13%. Retail investor expectations remained bearish.

7. **Overall Asset allocation** **Neutral**
   Despite a looming recession, we remain neutral in our stance towards risk assets as cross-asset risk premia are wider than at the start of the year. Among the negatives, failure to get inflation back into control would lead to further tightening of financial conditions which would worsen the recessionary impulse (longer/deeper). That, and a worsening of the geopolitical outlook (Russia-Ukraine, U.S.-China, China-Taiwan) are risks that can cause us to turn bearish on risk assets. On the other hand, a sustained improvement in inflation outlook and/or a further expansion of risk premiums would likely cause us to turn 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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