Multi-Asset perspectives

Courtesy of Principal Global Investors

November 2022

Highlights

Macro

- **COVID-19** made fresh headlines, but this time for the right reason – China's finally readying an exit from its "zero-COVID" policy three years after implementing it forcefully. The path is likely to be bumpy, but the political will seems to have been found. The changed approach should be growth positive.
- **Economic activity** continued to normalize lower as expected. Our provisional Global PMI edged lower (48.7), staying in contractionary territory for a 2nd month. Both DM (48.5) and EM PMIs (49.0) were below the 50 thresholds. 65% of the countries were in contractionary territory. While 46% saw higher sequential readings, and only 8% saw growth over the prior 12 months. Our Leading Regime Indicator (51.6) was flat but remained close to the contractionary level of 50. Global Economic Surprises were negative barring the Euro Area.
- **Global financial conditions** made a strong comeback but remained at their most restrictive since the Euro crisis in 2011. Improvements in credit and volatility components led the recovery. US and Chinese FCIs eased the most. In level terms, U.S. financial conditions remained at their tightest since the GFC recovery days of 2008-09.
- **Global inflation** remained unchanged at 6.9% in Oct'2022, showing signs of peaking. Only 13 of the 29 countries printed higher readings. 10-yr break-even inflation implied by U.S. TIPS fell 14bps to 2.37% while 5-yr break-even fell to 2.48% (both were modestly above the Fed comfort zone). The Global Inflation surprise was negative, as all regions other than Japan registered misses. In the U.S., inflation had its first miss since August, driven by core prices.
- **Our cross-asset implied volatility indicator** eased -11% on improved risk orientation. However, it remained 15% above its long-term average i.e., asset markets remain anxious about both monetary policy and economic outcomes.

Bottom-up

- Global bottom-up earnings revisions remained soft. MSCI AC World's **expected EPS growth** for 2022-23 was flat at 3%. The 3-month change improved to -2.4%, helped by U.S. dollar weakness. Energy, staples, and health care were the only sectors with positive earnings revision. Our preferred breadth measure, the global **3m Earnings Revisions Ratio,** was slightly weaker at 0.42 (i.e., downgrades exceeded upgrades marginally) with U.S. at 0.36.
- **YTD'22 Global credit rating upgrades to total changes** eased to 45% (55 downgrades & 45 upgrades out of 100) with HY at 35% and IG at 62%. In level terms though, U.S. IG remained very strong at 76%.

Valuations

- **Global equity valuations re-entered the expensive zone after a strong November recovery.** MSCI ACWI was cheaper than current levels 82% of the time in history, compared to 60% the month prior, the expensiveness driven almost entirely by U.S. comps. While U.S., India, Singapore, and Thailand were outrightly expensive, almost all other markets remained either in fair value or cheap zone.
- **U.S. IG and HY** spreads narrowed to 124bps and 448bps respectively. Based on our fundamental valuation models, each ended at the lower end of the fair valuation band. However, they ended well below the lower bands of our market-based fair value models. **IG spread ranks at 61st %ile, and HY 50th %ile relative to their history.**
- The **U.S. 10-yr treasury** yield, at 3.61% was 143bps above its 10-yr median. However, it's just below the lower band of fair value (3.7%) implied by our UST fair value models.

Markets

- **Multi-Assets:** Our global multi-asset index gained 6% in November'2022, powered by equities, treasuries, and credit. The YTD'22 drawdown narrowed to -14% from -19%.
- **Global Equities** recovered as a miss in U.S. core CPI opened doors to a Fed pivot to less hawkish. Several Fed speakers talked up a slower pace of rate hikes starting Dec'22. 38 out of the 40 markets we track ended in the green with a median local currency return of 5.5% (YTD'22 median return -5%). China's COVID pivot and an intentional package to support the beleaguered property sector triggered a massive rally in offshore listed Chinese stocks (Hang Seng 27%, H-shares 29%), which reduced their YTD'22 drawdown to -21% and -22% respectively. Globally, Quality outperformed. All sectors registered positive returns with Materials leading the pack.
- **Fixed income:** Principal Asset Allocation's Global Policy Rate indicator rose 27bps to 3.37% with15 hikes and a cut (Turkey). Principal Asset Allocation's Global Sovereign 10-yr Yield indicator fell 21bps to 3.92% with 26/29 countries seeing lower yields as markets moved to a less hawkish monetary policy path. The global 2-10 curve spread inverted to -7bps, with 17/29 countries in inversion. The U.S. curve stayed massively inverted at -70bps. The U.S. 3m-10yr curve, historically a strong leading indicator for recessions, inverted for the first time since Feb'20. Credit spreads narrowed for most categories.
- **Currencies:** Rising hopes of a policy pivot by the Fed checked the rampaging U.S. $ as 87% of the currencies we track ended with gains. For the year though, only Real, Mexican Peso and the Ruble were able to beat the greenback.
- **Commodities:** The GS commodity index dropped -2.5%. Industrial metals (12%) jumped after lagging all year on China's rethink of its COVID strategy and support to its property sector. Energy (-5.7%) weakened as the Russia-Ukraine war took a backseat. Besides, Chinese oil import demand remained muted and European storage data showed far more gas than initially anticipated. Global inventories of crude oil and oil products remain low, supporting outlook.

Key risks faced by markets

- Inflation control requires a deeper recession than the 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.
- 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.

Important information
This material covers general information only and does not take account of any investor's investment objectives or financial situation and should not be construed as specific investment advice, a recommendation, or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding an investment or the markets in general. The opinions and predictions expressed are subject to change without prior notice. The information presented has been derived from sources believed to be accurate; however, we do not independently verify or guarantee its accuracy or validity. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that the investment manager or its affiliates has recommended a specific security for any client account. Subject to any contrary provisions of applicable law, the investment manager and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided.

This material may contain 'forward-looking' information that is not purely historical in nature and may include, among other things, projections and forecasts. There is no guarantee that any forecasts made will come to pass. Reliance upon information in this material is at the sole discretion of the reader.

Proprietary model output is based upon certain assumptions that may change, are not guaranteed, and should not be relied upon as a significant basis for an investment decision. Forecasts for each asset class can be conditional on economic scenarios; in the event a scenario comes to pass, actual returns could be significantly higher or lower than forecasted. Because of the inherent limitations of all models, potential investors should not rely exclusively on the model when making an investment decision. Forecasts of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice.

Indices are unmanaged and do not consider fees, expenses and transaction costs are not available for direct investment. The information provided here is neither tax nor legal advice. Investors should speak to their tax professional for specific information regarding their tax situation.

This material is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Disclaimer:
Ahli United Bank B.S.C.
Bahrain: The views contained herein has been obtained from sources that **Ahli United Bank B.S.C. ("AUB"**) deems to be reliable but Ahli United Bank B.S.C. makes no representation about the accuracy, completeness or timeliness of any information prepared by a third party and assumes no liability for the reliance thereon. The opinions and predictions expressed in the materials are subject to change without prior notice and has not been prepared by or with the involvement of Ahli United Bank B.S.C.; however, Ahli United Bank B.S.C. does not independently verify or guarantee its accuracy or validity. Subject to any contrary provisions of applicable law, Ahli United Bank B.S.C. and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only and derived from numerous sources, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. IMPORTANT – If you are in any doubt about the contents of this document you should seek independent professional advice. AUB will not act and has not acted as your legal advisor to you in connection with this, and/or any related transaction and no reliance may be placed on AUB for advice or recommendations and/or solicitation of any sort. Ahli United Bank B.S.C. is licensed as a conventional retail bank by the Central Bank of Bahrain ("CBB"). For additional information about Ahli United Bank B.S.C., please visit www.ahliunited.com/bh.

Dubai International Financial Center: Ahli United Bank B.S.C. (DIFC Branch) is an entity duly authorised and regulated by Dubai Financial Services Authority ("DFSA") with its registered office at 1402 Al Fattan Currency House Tower 2 DIFC, Dubai, UAE. This document is being distributed for general information only. It does not constitute research material, independent research, an offer, recommendation or solicitation to enter into any transaction or adopt any hedging, trading or investment strategy, in relation to any securities or other financial instruments. It does not take into account the specific investment objectives, financial situation or particular needs of any particular person or class of persons and it has not been prepared for any particular person or class of persons. Please note that Ahli United Bank B.S.C. (DIFC Branch) offers financial products or services only to persons qualifying as Professional Clients or Market Counterparties under the DFSA rulebook. This information may not be relied upon or distributed to Retail Clients.

Egypt: The views contained herein has been obtained from sources that **Ahli United Bank (Egypt) S.A.E. ("AUBE")** deems to be reliable but AUBE makes no representation about the accuracy, completeness or timeliness of any information prepared by a third party and assumes no liability for the reliance thereon. The opinions and predictions expressed in the materials are subject to change without prior notice and has not been prepared by or with the involvement of AUBE; however, AUBE does not independently verify or guarantee its accuracy or validity. Subject to any contrary provisions of applicable law, AUBE and its affiliates, and their officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy and any responsibility arising in any way (including by reason of negligence) for errors or omissions in the information or data provided. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only and derived from numerous sources, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. IMPORTANT – If you are in any doubt about the contents of this document you should seek independent professional advice. AUBE will not act and has not acted as your legal advisor to you in connection with this, and/or any related transaction and no reliance may be placed on AUBE for advice or recommendations and/or solicitation of any sort. Ahli United Bank (Egypt) S.A.E. is licensed and regulated by the Central Bank of Egypt. For additional information about Ahli United Bank (Egypt) S.A.E., please visit www.ahliunited.com/eg.