Multi-Asset perspectives

Courtesy of Principal Global Investors

2022: The year that was

Macro

- **Manufacturing Growth** slowed even as lagging indicators like employment remained strong. Our Global PMI indicator entered recessionary territory on weak new orders. Our leading indicator was close to it. Services growth remained positive but is likely to slow down in 2023.
- **Inflation** consistently outperformed expectations, hitting multi-year highs in developed markets before easing in 4Q'2022, particularly in manufactured items. While lead drivers like commodity prices, freight rates, and supply bottleneck related cost pressures eased by the end of the year, services inflation (particularly housing) remained high. While it will rollover in 2023, the speed and magnitude present uncertainty.
- **Financial conditions** tightened considerably. Fed's terminal rate expectation started at 1.5%, ended near 5% by the end of the year.
- **China.** By year end, Beijing signaled a movement away from regulatory restrictions that had hampered certain technology services, while also easing some financing restrictions on the vital residential property sector. The Central Economic Work Conference appeared to indicate additional relief for residential real estate would be forthcoming in 2023. The rapid moves to drop many Zero COVID restrictions brought an initial wave of new infections, creating a challenging environment for economic re-opening that may impact manufacturing and services through the first quarter.
- **Uncertainty** dominated. Elevated volatility levels (well above their long-term average) and higher funding costs made it a tough year for leveraged strategies.

Bottom-up

- **Bottom-up earnings revisions** softened through the year. MSCI AC World's **expected EPS growth for 2022** started at 7%, ended at 3%. The breadth turned negative (60 downgrades for 40 upgrades). Energy (64%) Materials & Industrials (2% each) were the only sectors with positive EPS revisions. Communication services (-21%) and Consumer Discretionary (-18%) faced large chops.
- **Global credit rating upgrades to total changes** eased to 44% (56 downgrades for 44 upgrades) compared to 57% at the end of 2021. HY dropped to 34%, IG to 62%. In level terms, U.S. IG remained very strong at 75%.

Valuations

- **Global equity valuations** started the year very expensive but ended in fair value zone as higher interest rates took a toll. U.S., India, and Thailand remained outrightly expensive; all others were either in or near the cheap zone.

- **U.S. Corporate** spreads, that started the year expensive, widened into fair value zone for both IG (61st percentile) and HY (56th percentile) relative to their long-term trends. However, based on our fundamental and market-based valuation models, each was still on the expensive side. EM hard currency debt, however, was cheap on fundamentals.
- The **U.S. 10-yr treasury** yield, at 3.87% was 168bps above its 10-yr median. However, it was close to the 4.1% fair value level implied by our fair value fundamental models. For context, the fair value was 1.5% at the start of 2022.

Markets

- **Multi-Assets:** Deep hits from equities and fixed income caused our global multi-asset index to lose -16% in 2022, making it one of its worst years in recent history. Commodities were the only asset class to end in the green.
- **Global Equities:** Valuation contraction caused markets to end in the red as interest rates jumped. MSCI's All Country World Index contracted -18% in $ terms. 70% of the markets closed in the red with a median local currency return of -9%. The best was Turkey (197%), followed by Argentina (142%) and Chile (22%). Nasdaq (-33%) was easily the worst. Europe (Russian invasion, energy crisis) was at the eye of the storm, yet U.S. markets underperformed with S&P at -19% vs MSCI Europe (US$) at -15%. Regionally, only LatAm (8.9%) clocked positive $ return. Past winners got decimated as the old economy returned with vengeance. Energy was up 28%. Communication Services was down -36%, Consumer Discretionary & Infotech (-32% each) had forgettable years. Value trumped Growth. "Current" cash flow generating companies significantly outperformed "promised" cash flow generators.
- **Fixed income:** The traditional antidote to market risk-off didn't work as bond yields shot up (PGAA's Global Policy Rate indicator jumped 232bps to 3.66%, its 10-yr yield indicator jumped 161bps) alongside higher credit spreads, creating deep holes in bond portfolio total returns (Bloomberg Barclays Global Aggregate Index dropped -16% in $ terms). Cash/very short-duration securities were unscathed, benefiting from rising short-term yields. While 2022 was a disastrous year, the future looks brighter, given the substantial jump in portfolio carrying yields.
- **Currencies:** The Greenback had a stupendous year, riding a significant repricing of US policy rates (higher). Only 5 currencies could hold their forte, of which the Brazilian Real and Mexican Peso were the best (gained 5% each). Kudos to their central banks for being ahead of the Fed in tightening policy. The other standout currency was the Japanese Yen (JPY). The U.S. $ was up 30% at one point against JPY, before closing with a 14% gain as the Bank of Japan (BOJ) was forced to intervene. It was also forced to tighten its ultra-loose monetary stance by resetting the 10-yr yield target at 0.50% vs 0.25%, which helped JPY in the 4th quarter.
- **Commodities:** Higher yields dampened the allure for precious metals, while base metals were knocked down by growth concerns (primarily in China). Supply disruptions in Ukraine helped Agricultural commodities. Energy (GS Energy Spot Index gained 14%) was the star performer on geopolitical risks relating to the Russian invasion of Ukraine. Both crude oil and natural gas prices touched multi-year highs before rolling over at the end of the year as the supply situation turned out be less drastic than feared. With Europe forcing itself off Russian oil, oil and gas supply chains were redrawn. China and India are seeing the share of discounted Russian oil rise in their imports while Middle eastern oil is finding its way into European shores in greater proportion. US will become a large exporter of liquefied natural gas to Europe as liquefaction facilities get built on both sides of the Atlantic.

Looking Ahead

1. COVID & Restrictions **Positive**

China's COVID-19 policy flip makes remains a positive, though the path will not be straightforward.

2. Growth **Negative**

Macro indicators confirm that the global economy is slowing, and likely to get into the recessionary zone in the second half of 2023. Growth concerns emanate from negative household real income growth, tightened financial conditions and significantly reduced housing affordability. Employment growth, which remained strong in 2022, should turn negative by 2Q'2023. Corporate inventory build will slow down too. While China's policy stance has turned stimulative, efforts aren't quite game-changing yet.

3. Inflation **Negative**

Inflation remained centerstage in 2022 but growth concerns are likely to become more dominant in 2023. Several leading components (freight rates, supply bottlenecks, commodity prices) already confirm a rolling over of goods price inflation, with the real question for 2023 being the speed at which services inflation normalizes.

4. Global financial conditions **Negative**

Global financial conditions will be kept tight unless inflation starts rolling over decisively. While we keep this factor at negative, recognizing that the Fed's not ready to call it a victory over inflation yet, we are conscious that a lot of distance may already have been travelled.

5. Valuations **Neutral**

- **Risk-free rates:** Higher risk-free rates are presenting meaningful positive yielding anti-fragile alternatives.
- **Equity Valuations** are expensive for U.S., but cheap for most other markets.
- **Corporate spreads** are wider than at the start of 2022 but likely to widen further as recession gets closer.
- In **Currencies,** the U.S.$ remains expensive but remains the best absorbent of investor de-risking flows.

6. Technicals **Neutral**

The large drawdown in 2022 tilted the technical picture from overbought to neutral. Retail investor optimism is low, price momentum-based indicators aren't extended by any means for risk assets, and equity hedging through options remains high. If risk assets sell off some more, we would be tempted to move this factor to Positive.

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, and financial conditions have already tightened considerably. While inflation remains important, the key concern for 2023 is linked to growth i.e., the timing, depth, and length of the recession, if it happens. Our Economic group expects a mild one in Europe in the first half, and a mild one in US in the second. However, should inflation prove stickier, downside risks will rise disproportionately. On the positive side, if inflation rolls over faster, policy makers will start letting financial conditions ease, which will support risk assets.

Key risks

- 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

Risk considerations
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