Multi-Asset perspectives

Courtesy of Principal Global Investors

January 2023

Macro

- **Economic activity** stabilized due to boosts from China and Europe and declining inflation. Our Global PMI edged higher (49.1) as both EM (50.5) and Europe (48.7) moved up, but U.S. (47.4) continued to decline. 65% of the countries tracked remained in contraction; however, 50% of countries tracked also saw sequential improvement. While U.S. wage growth started to decelerate, the employment picture remained strong. Our Leading Regime Indicator (50) hit its first "no-growth" reading since June 2020. Global Economic Surprises were broadly flat. China and Europe saw slightly positive surprises, Japan was flat but U.S. continued to miss.
- **Global financial conditions** eased, driven by improvement in all sub-segments i.e., spreads, rates, momentum, and volatility (our volatility indicator dropped -13% to move back towards its long-term average). Regionally, U.S. and China FCI eased the most while Europe FCI tightened on slower monetary growth. U.S. Fed slowed its hiking pace to 25bps, guided for two more hikes while becoming more data dependent. It did not push back against the recent easing in financial conditions, implying a shift in policy from continuous incremental tightening to maintaining policy tight versus levels when they started hiking early last year.
- **Global inflation** eased to 6.1% in Dec 2022. Only 11 of the 29 countries printed higher readings. 10-yr break-even inflation implied by U.S. TIPS fell 5bps to 2.25% while 5-yr break-even fell to 2.33% (both were only modestly above the Fed comfort zone around 2%). Global Inflation surprises were negative, driven by China and Europe.

Bottom-up

- Global bottom-up earnings revisions remained soft. MSCI AC World's **expected EPS growth** for 2023 edged down to 2% in $ terms. The 3-month change improved to 1.0%, riding a weak U.S. Dollar (DXY was -8.5% in 3m). US Energy earnings revisions turned negative (-4%) due to lower oil prices, leaving Consumer Staples as the only sector with positive revisions. The global **3m Earnings Revisions Ratio** was flat at 0.41 (41% upgrades, 59% downgrades).
- **YTD'23 Global credit rating upgrades to total changes** was at 39% (61% downgrades, 39% upgrades) with HY at 35% and IG at 50%. U.S. IG, however, remained strong at 70%.

Valuations

- **Global equity valuations re-entered the expensive zone after a strong showing in January.** MSCI ACWI was cheaper than current levels 84% of the time in history, compared to 57% the month prior. US comps drove the expensiveness. While Singapore, and Thailand were also outrightly expensive, all other markets remained either in fair value or cheap zone.

- **U.S. IG and HY** spreads narrowed to 110bps and 420bps, respectively. Based on our fundamental and market valuation models, both were below the lower end of the fair valuation bands.
- The **U.S. 10-yr treasury** yield, at 3.51% was 130bps above its 10-yr median. However, it was just below the lower end (3.6%) of the fair value band implied by our UST fair value models.

Markets

- **Multi-Assets:** Our global multi-asset index gained 5% in January 2023, powered by equities, treasuries, and credit. The 12-month drawdown narrowed to -8.5% from -15.5% at the end of 2022.
- **Global Equities** continued their recovery on further evidence of inflation normalization, which helped build the case for a soft-landing. Thirty-five out of the 40 markets we track ended in the green with a median local currency return of 6.4%. China's rapid reopening lent support to offshore Chinese equities (up 10-11%). Lower yields caused aggressive short covering in beaten down growth stocks. Mutual fund and ETF flows favored Asia and Europe (both beneficiaries of Chinese reopening) while U.S. faced outflows.
- **Fixed income:** Principal Asset Allocation's Global Policy Rate indicator rose 2bps to 3.69% with 8 hikes and no cut. Its Global Sovereign 10-yr Yield indicator fell 22bps to 3.92% with 25/29 countries seeing lower yields as markets baked in less hawkish monetary policy cues. The global 2-10 curve spread inverted to -11bps, with 16/29 countries in inversion. The U.S. curve stayed significantly inverted at -69bps. The U.S. 3m-10yr curve inversion, historically a strong leading indicator for recessions, deepened to -118bps. Credit spreads narrowed in most categories as investors warmed up to both IG and HY corporate bonds.
- **Currencies:** U.S. Dollar longs were cut as its forward carry advantage rolled over. Eighty percent of the currencies we track ended with gains versus the greenback, with the DXY index falling 1.4%.
- **Commodities:** The GS commodity index dropped -0.7% with losses in Energy (-3.4%) outweighing gains in industrial (8.7%) and precious metals (5.8%). The weighted-term structure for commodities turned into contango from backwardation as near-term supply worries faded.

US Housing Indicators

- U.S. Home prices are dropping but there is no evidence of a crash given strong employment trends and tight vacancy rates. Markets where prices jumped 25-30% in 2021 are more at risk.
- Lower mortgage rates and house prices should revive some interest in markets in 2023.
- Office sector has some distance to travel on the price front.
- In the U.S., outstanding mortgages to home value ratio was at 27% in June '22. Assuming prices decline 15%, the ratio would still be at a very modest 32%. In contrast, it stood at 50% before the GFC, which implies limited macro risks.

Looking Ahead

1. COVID & Restrictions **Positive**

China's COVID-19 policy flip was the reason we upgraded this to Positive the month prior and keep it unchanged.

2. Growth **Neutral from Negative**

Macro indicators confirm a slowing economy but one that is not crashing. A recession sometime in 2023 is still our base case but the magnitude and duration of it will likely be shallower than initially expected, due to the recent drop in energy prices globally, easing in financial conditions, and continued strength in employment. Tail risks have reduced, too. While risks linked to inflation and housing markets remain, we shift the factor to Neutral from Negative.

3. Inflation **Neutral from Negative**

Inflation remains centerstage. Several leading components (freight rates, supply bottlenecks, commodity prices) are pointing towards a lower trajectory in headline inflation (confirmed by our **Inflation leading indicator).** Though the picture remains blurred on core inflation, we upgrade the inflation factor to Neutral from Negative to reflect the progress made in the last few months.

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

Global financial conditions have tightened since last year but are not tightening any more due to a less hawkish monetary policy stance, and reduced tail risks that flow into financial conditions through spread, equity, and volatility effects. Accordingly, we upgrade this factor to Neutral from Negative.

5. Valuations **Neutral**

- **Risk-free rates:** Higher risk-free rates are presenting meaningful positive yielding anti-fragile alternatives.
- **Equity Valuations** got even more expensive for U.S. and few others, but cheap otherwise.
- **Corporate spreads** are close to the expensive zone, and not factoring a recession which remains our base case.
- In **Currencies,** the U.S.$ remains over-valued, but remains the best anti-fragile absorbent of investor de-risking flows.

6. **Technicals** **Neutral**

Strong market returns since the lows of Sep'2022 have reduced bearish positioning in risk assets in several respects (retail investor sentiment is no longer as bearish as before, hedging implied by the put/call ratio has eased, and 88% of the markets are above their 50-day and 200-day moving averages). On the other hand, speculative bets on both S&P 500 & Nikkei remain net short. Overall, we keep this factor as neutral.

7. Overall asset allocation **Neutral**

We remain neutral in our stance towards risk assets. On one hand, our growth outlook has improved marginally, yet on the other, valuations are beginning to look expensive again (particularly U.S. equities) which should cap market gains unless earnings growth recovers strongly. Tail risks remain too, particularly as it relates to failure to bring core inflation back towards the 2-2.5% range.

Key risks

- The recent improvement in inflation readings does not last more than a few months, with core inflation staying above policymaker goals. That could draw them into taking monetary policy into the zone which causes a deeper recession.
- The global real estate sector faces a hard landing.
- Geopolitical risks worsen, both in the ongoing Russia-Ukraine conflict, and US-China relationship.
- Tax rates rise globally as governments try to flatten the income curve.

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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