# Multi-Asset perspectives

Courtesy of Principal Asset Management

**February 2023**

## Macro

- **Economic activity** was resilient, increasing the chances of a soft-landing. Our Global PMI edged up to 49.8 driven by a major surprise in China (52.6) and stable readings in the U.S. (47.7) even as 58% of the countries remained in contraction. The one-month reading of our Leading Regime Indicator rebounded to 51.8, keeping the 3-month reading in weak expansion at 51.1. Global Economic Surprises turned positive due to beats in China and Japan. While U.S. surprises were still negative, recovering soft data reduced their magnitude. Employment trends remained strong in both the U.S. and globally, counterbalancing a year of significant monetary tightening.

- **Global financial conditions** tightened due to higher rates as global inflation surprises turned positive, and the global economy showed resilience which reinforced the "higher for longer" monetary policy narrative. Regionally, U.S. conditions tightened the most with terminal fed fund rate expectation shooting up to 5.5%. Expectations of rate cuts in 2023 took a knock. While credit spreads remained tight, cross-asset volatility bounced back above its long-term average, contributing to tightening conditions.

- **Global inflation** was stable around 6.2% in Jan 2022, halting a 3-month decline. 17 of the 29 countries printed higher readings, suggesting that the path to normalization will be bumpy. 10-yr break-even inflation implied by U.S. TIPS rose modestly to 2.38% but the 2-yr break-even surged 85bps to 3.18%, way above the Fed comfort zone around 2%. While Inflation surprises were negative in China, Europe, and Japan, they turned positive in the U.S.

## Bottom-up

- Global bottom-up earnings revisions remained soft. MSCI AC World's **expected EPS growth** for 2023 edged down to 1% in $ terms. The 3-month change fell to -2%. Cyclical sectors (energy, materials, and industrials) started seeing deeper and more sustained earnings cuts. Consumer Staples remained the only sector with positive revision. The global **3m Earnings Revisions Ratio** for 2023 was at 0.40 (40% upgrades, 60% downgrades) vs 0.39 the month prior.

- **YTD'23 Global credit rating upgrades to total changes** improved a tad to 42% (42% upgrades, 58% downgrades) from 39%, with HY at 36% (35%) and IG at 52% (50%).

## Valuations

- **Global equity valuations remained relatively expensive despite the modest correction in February.** MSCI ACWI was cheaper than current levels 75% of the time in history (84% the month prior). U.S. and Thailand remained outrightly expensive. All other markets remained either in fair value or cheap zone.
- **U.S. IG and HY** spreads remained rangebound despite large moves in interest rates, finishing at 124bps and 412bps, respectively. Based on our market based FV valuation models which assign a high weight to market volatility, both remained below the lower end of the fair value bands. **However, they were at fair value based purely on fundamental factors which showed an improvement last month.**
- The **U.S. 10-yr treasury** yield, at 3.92% was 171bps above its 10-yr median but within the fair value zone implied by our UST fair value models.

## Markets

- **Multi-Assets:** Our global multi-asset index lost -3% in February 2023 which reduced YTD '23 gain from 5% to 2%.
- **Global Equities** paused on worries that stronger growth and positive inflation surprises would cause the Fed and ECB to adopt a "higher for longer" stance. 17 out of the 40 markets we track ended in the red with a median local currency return of -1.1%. The China reopening trade ran out of steam causing offshore Chinese equities to underperform (9-11% drawdowns). In a month of inconsistent style performance, growth outperformed marginally in the U.S., but struggled in every other region. Low Volatility did well, followed by Value. Mutual fund and ETF flows continued to favor EM and Europe (beneficiaries of Chinese reopening) at the expense of the U.S.
- **Fixed income:** Rates and yields move up substantially, but spreads were generally softer. Our Global Policy Rate indicator rose 20bps to 3.89% with 11 hikes and 1 cut (Turkey). Terminal fed funds rate pricing moved up 50-70bps in the 2-5yr bucket. Our Global Sovereign 10-yr Yield indicator rose 17bps to 4.09% with 26/29 countries seeing higher yields. The global 2-10 curve spread inversion deepened to -29bps, with 17/29 countries in inversion. **The U.S. curve inversion deepened to -96bps, its lowest level since the 80s.**
- **Currencies:** A hawkish policy tilt helped the U.S. Dollar to its best month in five. 93% of the currencies we track ended with losses versus the greenback, with the DXY index gaining 2.7%. The Mexican Peso performed the best, rising 2.4%.
- **Commodities:** The GS commodity index dropped -4% as commodity markets adjusted to a more hawkish interest rate setting. The weighted-term structure for commodities turned into contango from backwardation as near-term supply worries faded. However, oil prices remained in backwardation with 3-12month WTI at -$3.9/barrel.

## US Housing Indicators

- U.S. Home prices stay on the downward path (they have dropped -5% from the peak) 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 exposed. Tight rental markets continue to support multi-family housing rents.
- Mortgage rates need to peak for housing demand to start recovering. Lower rates and lower prices will aid home affordability hovering near multi-year lows. Cost of outstanding mortgages is still low, however.
- Rising cap rates are raising the hurdle for future property price gains.
- In the U.S., outstanding mortgages to home value ratio was at 27% in Sep'22. Assuming prices decline 15%, the ratio would still be at a very modest 32% compared to 50% before the GFC, which implies limited macro risks.

## Looking Ahead

**1. COVID & Restrictions** **Positive**

China's COVID-19 policy flip is still intact, allowing us to keep this factor at positive.

**2. Growth** **Neutral**

Macro indicators confirm a slowing but resilient economy, powered by the consumer. We now expect the U.S. recession to start in 4Q 2023 in our base case versus 3Q 2023 earlier. We also expect it to be shallower, both in size and duration due to dropping energy prices and continued strength in employment. Tighter financial conditions present the biggest challenge to growth. While overall tail risks have reduced, a slower drop off in inflation and growth will likely push policy rates even higher than currently anticipated by markets, taking the U.S. economy towards our bear case of a prolonged recession lasting close to 2 years.

**3. Inflation** **Neutral**

We moved this factor to neutral from negative last month in anticipation of a steeper drop due to base effects. We admit that the readings in Feb 2023 showed that the declining trajectory hit a road bump due to higher core and energy inflation. We keep it at neutral for the time being, aware that risks have tilted marginally towards inflation staying higher for longer in the last few weeks.

4. **Global financial conditions** **Neutral**

We had expected global financial conditions to have peaked when we upgraded this factor to neutral from negative the month prior. Since then, higher rates, yields and volatility have caused conditions to tighten as inflation and growth surprised on the upside. We keep this at neutral for now but acknowledge that risks of further tightening are beginning to rise again.

**5. Valuations** **Neutral**

- **Risk-free rates:** Higher risk-free rates are presenting meaningful positive yielding anti-fragile alternatives.
- **Equity Valuations** are still expensive for U.S. but are cheap otherwise.
- **Corporate spreads** are in the neutral zone on our fundamental fair value models, but expensive on market-based models. If our recession call comes right, spreads should widen from current levels.
- In **Currencies,** the U.S.$ is still extremely over-valued but is still the best anti-fragile absorbent of investor de-risking flows.

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

Speculative bets on both S&P 500 & Nikkei remained net short. Retail investor sentiment remained weak. But risk markets looked extended based on prices relative to their 200-day moving averages. Hedging implied by the put/call ratio remained near long-term averages. Overall, we keep this factor at neutral.

**7. Overall asset allocation** **Neutral**

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

### Key risks

- The improvement in inflation readings does not last more than few months, with core inflation staying above policymaker goals. That could draw them into pushing monetary policy into the zone which causes a deeper recession (our bear case).
- The global real estate sector faces a hard landing, led by the office sector which is facing deep challenges.
- Geopolitical risks worsen, both in the ongoing Russia-Ukraine conflict, and U.S.-China relationship.
- Tax rates rise globally as governments try to flatten the income curve.

**Risk considerations**
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