Multi-Asset perspectives

Courtesy of Principal Asset Management

March 2023

Macro

- **Economic activity** conveyed mixed signals in Mar '23 after showing signs of recovering in February. Our Global PMI came at 49.0, giving back the entire gain made in Feb '23. US (46.3 from 47.7) and EU (47.7 from 48.6) weakened the most among major economies, while China's momentum slowed (51.9 from 52.6). Sixty-two percent of the countries were in contraction. However, the one-month reading of our Leading Regime Indicator rebounded to 53.6, pushing the 3-month average to a solid 51.8. Global Economic Surprises were in neutral zone after a positive February, with weakness in Europe nullifying the strength in China. Global employment trends remained strong.

- **Global financial conditions** were marginally tighter due to wider spreads due to the banking stress that hit markets during the months. The interest rate component was stable as lower bond yields balanced higher policy rates. Volatility & momentum contributed to ease as equities had a positive month despite the banking stress. Regionally, U.S. conditions eased a tad (bond yields were significantly lower) while Euro-Area tightened the most (wider spreads and higher policy rates).

- **Global inflation** eased to 5.7% in Feb '23 from 6.2% the month prior. Nineteen of the twenty-nine countries printed lower readings in an encouraging sign. However, a significant distance still needs to be traveled before inflation can reach policymaker goals. 10-yr break-even inflation implied by U.S. TIPS eased to 2.3% but the 2-yr break-even dropped -50bps to 2.7%, within striking distance of the Fed comfort zone in the 2-2.5% range. Inflation surprises went deeper into negative territory in a welcome sign for policymakers.

Bottom-up

- Global bottom-up earnings revisions remained soft. MSCI AC World's expected EPS growth for 2023 remained at a meager 1% in $ terms. The 3-month change was at -2%. Energy and IT continued to face negative earnings revisions. The global 3m Earnings Revisions Ratio for 2023-24 was at 0.43 (43% upgrades, 57% downgrades) vs 0.44 the month prior.

- **YTD'23 Global credit rating upgrades to total changes** were stable around 41% (41% upgrades, 59% downgrades) with HY at 35% and IG at 55%.

Valuations

- **Global equity valuations remained expensive.** MSCI ACWI has been cheaper than current levels just 87% of the time in history (78% the month prior). US and Thailand remained outrightly expensive. Other markets, though, were either in fair value or cheap zone.

- **U.S. IG and HY** spreads widened as banking stress hit credit markets. US IG widened 14bps to 138bps, while US HY widened 43bps to 455bps. Both remained expensive based on our fundamental and market based Fair Value models (fundamental models are purely based on macro-economic indicators, while market-based models assign a high weight to market volatility).

- The **U.S. 10-yr treasury** yield, at 3.47% was 123bps above its 10-yr median. It was below the fair value zone of 4.0-4.8% implied by our UST fair value models.

Markets

- **Multi-Assets:** Our global multi-asset index gained 3% in Mar ’2023 which took YTD ’23 return to 5%.

- **Global Equities** had a remarkable month despite stress caused by bank failures/ bailouts. While the median local currency return was -0.6% and 60% of the markets were down, Nasdaq (6.7%), S&P 500 (3.5%), and China H shares (5.9%) clocked strong returns. Technology got a boost from sharply lower US treasury yields and concerns that banking sector deleveraging would hurt cyclical Value stocks. China was helped by encouragement provided by its leadership to its tech giants in another sign of truce. Growth and Quality were winning styles in a month that saw financials hit particularly hard. IT and consumer discretionary stocks outperformed.

- **Fixed income:** Policy rates continued to rise, but yields dropped sharply in the US while credit spreads widened on concerns linked to the banking stress. Our Global Policy Rate indicator rose 18bps to 4.07% as thirteen more hikes took place. The terminal fed funds rate pricing dropped 60-80bps in the 2-4yr buckets as markets braced for the Fed to start cutting rates in 4Q ’23 due to the banking stress. Our Global Sovereign 10-yr Yield indicator dropped -26bps to 3.90 % with 27/29 countries seeing lower yields. The global 2-10 curve spread inversion reduced to -13bps from -21 bps, but 16/29 countries were still in inversion. The U.S. curve inversion eased to -56bps from -96bps as expectations of rate cuts pushed 2-yr yields down sharply.

- **Currencies:** A sharp drop in US treasury yields shaped outcomes on the currency front, where the US$ dropped against 80% of the currencies we track it against. DXY weakened -2% while the MSCI EM FX index appreciated 1.5%.

- **Commodities:** The GS commodity index dropped -1%, dragged by lower oil/gas prices on growth concerns. Precious metals rallied 8.7% on lower treasury yields, $ weakness and the flight to safety. However, OPEC announced a surprise 0.5mbpd cut in output (Russia had already cut an equivalent amount earlier) on 1st April which propelled energy prices sharply higher in trading thus far in April.

US Housing Indicators

- U.S. Home prices have dropped -5% from the peak based on the Case-Schiller index. The yoy growth slowed to 2.6% in Jan '23 and will turn negative in Mar '23 even if prices hold at current levels. The wind-down in prices has been orderly, given strong employment trends and tight vacancy rates. Technology-sensitive markets where prices jumped 25-30% in 2021 are seeing larger corrections. Fed's latest Survey on housing shows the following trends –

    - 1yr price growth expectation lowest @2.7%yoy since the series started in 2014
    - Rent growth expectations are getting rationalized lower at 8% vs 12% last month
    - Refinancing expectations touched a new low of 4.4%

- There are nascent signs of housing affordability and demand beginning to find floors, though mortgage rates have not declined as much as the drop in long treasury yields would imply. Cost of servicing outstanding mortgages remains low.

- Cap rates continue to adjust higher particularly in the Office space where fundamental concerns exist. Other segments reflect higher rates more than fundamental concern of the type faced by Offices.

Banking Stress

- March saw four very significant banking events (three in the United States, one in Europe) that brought back memories of the Global Financial Crisis (GFC) of 2008-09 when some large US financial institutions were bailed out through mergers (Bear Sterns, Merrill Lynch) or allowed to fail (Lehman Brothers) or put into conservatorship (AIG) or put into FDIC receivership (Washington Mutual).

- Silicon Valley Bank (SVB) and Signature Bank (SB) became the 2nd and 3rd largest bank failures in the U.S. history, following Washington Mutual. Earlier, Silvergate Bank, a player in the cryptocurrency space, had to shut itself down following losses linked to crashing cryptocurrency prices and the failure of FTX, a crypto exchange. Signature Bank's collapse too was tied to the meltdown in the cryptocurrency space that led to deposit flight. SVB crashed due to a deposit flight as the Venture Capital companies that constituted a large chunk of its deposit base started withdrawing money en masse, as the Bank struggled to raise capital to shore up capital needed to offset losses it incurred in selling securities well below acquisition cost.

- Across the Atlantic, Switzerland's' second largest bank, UBS acquired Credit Suisse (CS), in a decision forced by Swiss Regulators to contain a crisis of confidence that had started to spread across global financial markets. CS had long struggled to win investor trust in its strategies, saddled with losses from poor business decisions and significant regulatory risks.

- The action taken by regulators was swift as market stress ballooned in a short span of time. US FDIC insured all depositors of the failed U.S. banks while working out asset/deposit sales. Swiss regulators sacrificed $16bn of AT1 bondholders in CS to strike a deal that valued CS equity at $3.5bn. The steps taken by regulators brought back bids to equity assets, helping equity markets close March'23 with gains either side of the Atlantic.

- An important distinction between the GFC and this episode of banking stress is that the former was primarily about asset quality concerns, with banks caught holding weak mortgages and levered structured assets. This time around, asset quality concerns are not significant. A few banks do face an asset-liability (ALM) mismatch challenge, given the sharp increase in policy rates since the end of 2021, which has put their asset book yields significantly below the incremental cost of raising deposits to fund outflows. Indeed, banks are losing free deposits (savings/current) to money market funds or term deposits carrying a much higher rate, a trend which is likely to continue for as long as the short-end rates remain high. Banks with strong ALM procedures, diversified deposit bases and prudent risk management systems do not face similar risks and may even be able to expand their balance sheet size.

- At a macro level too, risks are muted relative to the global financial crisis. Banking reform since then has resulted in banks holding more capital relative to assets. In fact, the non-financial sector debt in U.S. declined sharply relative to its GDP since the period, with US sovereign debt seeing a meaningful expansion.

Looking Ahead

1. Growth **Neutral**

Macro indicators confirm a slowing but resilient economy, powered by the consumer. We continue to expect the U.S. recession to start in 4Q 2023. We expect it to last three quarters with GDP contracting -0.4%. Having said that, if inflation does not fall back towards policymaker targets, financial conditions will have to be tightened more, which could result in our downside scenario of a protracted recession lasting eight quarters with a total GDP contraction of 1.4%. The current financial sector woes, with significant tightening of lending starts, could result in a similar outcome too as credit creation slows down considerably. The upside case is one of glorious disinflation where growth is positive but low, and wage gains moderate due to higher participation rates.

2. Inflation **Neutral**

We keep this at Neutral as we expect continued progress in coming months, encouraged by the noticeable drop in headline inflation in Feb ’23. At the same time, we remain cognizant that core services inflation needs to drop at a faster pace in coming months for policymakers to feel closer to their inflation goals.

3. **Global financial conditions** **Neutral**

We retain this factor at neutral for the time being, acknowledging that risks are tilted to the upside. Continued banking stress would impact credit spreads, volatility, and monetary growth adversely, tightening conditions significantly more than our base case.

4. Valuations **Neutral**

- **Risk-free rates:** Though risk-free yields declined last month, they continue to present meaningful positive yielding anti-fragile alternatives.
- **Equity Valuations** remain expensive for U.S. but are neutral/cheap otherwise.
- **Corporate spreads** are a tad expensive both on our fundamental fair value and market-based models. If our recession call comes right, spreads should widen from current levels.
- In **Currencies,** the U.S.$ remains over-valued, but is still the best anti-fragile absorbent of investor de-risking flows.

5. **Technicals** **Neutral**

Speculative bets on S&P 500 remained net short. Retail investor sentiment remained very 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 as neutral.

6. **Overall asset allocation** **Neutral**

We stay neutral in our stance towards risk assets with the bias towards reducing long exposure during risk-on rallies. While the economy is showing resilience and risk-free yields are off their peak, equity valuations are still expensive (particularly U.S. equities) which should cap market gains unless earnings growth recovers strongly. Tail risks relating to banking stress add to those from a failure to bring core inflation back towards the 2-2.5% range.

Key risks

- We add a new risk i.e., potential contagion from the banking sector woes. While macro variables look reasonable, the ALM mismatches could lead to a significant slowdown in credit creation.
- Failure to bring inflation back under control soon enough could cause policymakers to push monetary policy into the zone which causes a deeper recession (our downside 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 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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