Multi-Asset perspectives

Courtesy of Principal Asset Management

April 2023

Macro

- **Economic activity** slowed a tad in April. Our Global PMI slid to 48.4, dragged by China (49.2 from 51.9) while DM ended flat as weaker EU (46.7 from 47.7) offset an improvement in U.S. (47.1 from 46.3). Breadth remained weak as seventy-three percent of the countries were in contraction. The one-month reading of our Leading Regime Indicator weakened to 51.8 but the 3-month average ticked up, diverging from the signal being sent by PMIs. Global Economic Surprises were in negative zone, with misses in the U.S., China, and Europe overshadowing a beat in Japan. Global employment trends, however, remained strong.

- **Global financial conditions** were broadly stable. The interest rate component was stable, spreads narrower, asset market volatility lower, and monetary growth weaker. Regionally, conditions eased the most in Japan as expectations of a reversal in Bank of Japan's ultra-easy monetary policy were belied in its first meeting under new Governor Ueda. Conditions in core Euro-Area tightened the most on weak monetary growth.

- **Global inflation** eased to 4.8% yoy in Mar'23 from 5.7% the month prior, with DMs at 5.3% and EMs at 4.2%. Twenty six of the twenty-nine countries printed lower readings in a welcome sign. However, a significant distance remains to be traveled before inflation can reach policymaker goals, particularly in developed economies where core inflation has been stickier than expected initially. On the other hand, market-based inflation measures (U.S. CPI implied by TIPs) dropped to a range of 2.15%-2.25% for 2, 5 and 10 yrs, well within Fed's comfort zone. Global Inflation surprise remained negative as large misses in the U.S. and China easily washed-out milder beats in Europe and Japan.

Bottom-up

- Global bottom-up earnings revisions were unchanged. MSCI AC World's **expected EPS growth** for 2023 remained at 1% in $ terms. The 3-month change remained at -2%. Communication services was the only sector with positive earnings revisions. Energy and materials saw noticeable negative revisions. The global 3m Earnings Revisions Ratio for 2023-24 was at 0.43 (43% upgrades, 57% downgrades) vs 0.39 at 12/31/22, showing signs of bottoming.

- **YTD'23 Global credit rating upgrades to total changes** improved to 43% (43% upgrades, 57% downgrades) from 41%. HY remained weak at 35% while IG improved from 55% to 60%.

Valuations

- **Global equity valuations remained expensive**. MSCI ACWI has been cheaper than current levels 87% of the time in history (same as the month prior). All categories of U.S. equities barring small and mid-caps remained expensive. Other markets were either in fair value or cheap zone.
- **U.S. IG and HY spreads narrowed** ~3bps each as the regional U.S. banking stress was contained by quick regulatory action. U.S. IG and HY finished at 126bps and 452bps, respectively. 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 3.42%** was 115bps above its 10-yr median. However, it was below the fair value zone of 3.9-4.6% implied by our UST fair value models.

Markets

- **Multi-Assets**: Our global multi-asset index gained 1% in Apr 2023 which took YTD ’23 return to 6%.
- **Global Equities** had a decent month after an eventful March. The median local currency return was 1.9%. 78% of the markets were up with EEMEA (5.2%) and Europe (4.2%) clocking strong returns. China (-5.2%) gave back gains from the month prior as geopolitical tensions increased with the U.S. threatening more restrictions on technology transfers to China. Globally, financials and energy outperformed after underperforming in March. Momentum was the winning style as Growth stocks took a breather after a spectacular rally in March.
- **Fixed income**: The global rate indicator was almost unchanged at 4.1%, with few Central banks having meetings in April. For the U.S., while markets price in another rate hike in May, they are also pricing 75-100bps of rate cuts in the following 12 months, in defiance of Fed commentary that rates are very unlikely to be cut. Our Global Sovereign 10-yr Yield indicator eased -3bps to 3.87% with 15/29 countries seeing lower yields. The global 2-10 curve spread inverted to -19bps from -14bps, with 17/29 countries still in inversion. The U.S. curve inversion was unchanged at -58bps.
- **Currencies**: US$ weakened against 40% of the currencies we track it against (80% in the prior month). It weakened -1% against the DM basket while gaining 0.3% against the MSCI EM FX basket.
- **Commodities**: The GS commodity index dropped -1.6%, dragged by lower agricultural and industrial metal prices. Precious metals extended their March rally in gaining 1%. The surprise OPEC output cut propelled crude prices above 80 USD/bbl before worries about global economic growth caused them to close at $77/bbl.

US Housing Indicators

- U.S. home prices have dropped -5% from the peak based on the Case-Schiller index. The yoy growth slowed to 0.4% in Feb ’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. Prices in the industrial belt in central and eastern U.S. remain firm.
- There are signs that housing affordability and demand are beginning to find floors, though mortgage rates have not declined as much as the drop in long treasury yields would imply.
- While new mortgage costs have gone up ~50% due to higher rates (the difference between monthly EMI for a home costing $500,000 with 80% LTV, 30yr mortgage priced at 6.8% vs 3%), the cost of servicing outstanding mortgages remains low (3.5%) for the system due to a predominant share of fixed rate mortgages taken at low rates.
- Cap rates continue to adjust higher particularly in the Office space where significant fundamental concerns exist. The rise in cap rates in other segments is more reflective of higher cost of funds due to higher interest rates.

Banking Stress

- March had seen 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 large U.S. 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) become the 2nd and 3rd largest bank failures in U.S. history. Silvergate Bank, a player in the cryptocurrency space, had to shut itself down. Across the Atlantic, UBS gobbled up Credit Suisse (CS). Regulators engineered these to stem adverse contagion effects. All deals had commonalities i.e., protection for depositors and large losses for equity/subordinate bond holders.
- April saw another regional bank, First Republic (FRC), meet its fate. After weeks of attempts to find a permanent solution to its problem of deposit flight, regulators sold the banks' deposits and assets to JP Morgan with depositors protected, equity/bonds facing write-downs and FDIC guaranteeing losses to JP Morgan to an extent.
- We continue to believe that the current bank crisis is not going to infect the entire U.S. banking system like it did in 2008-09. Banks with strong ALM (asset-liability management) procedures, diversified deposit bases and prudent risk management do not face similar risks and may even be able to expand their balance sheet size. However, more banks with asset-liability mismatches of the type faced by SVB, SB, and FRC could be sold to larger institutions given the large negative carry between the cost of new deposits and their existing asset yields. We also expect a sharp margin contraction for lenders that must shore up deposits by paying current market rates. Indeed, banks continued to lose low-cost deposits (savings/current) to money market funds or term deposits carrying a much higher rate in April.
- At a macro level, too, risks are limited relative to the global financial crisis. U.S. financial sector debt/GDP has dropped to 0.76 from a pre-GFC high of 1.21. While banking reform has resulted in banks holding more capital relative to assets, we expect regulators to tighten norms further, focusing on ALM risks and methodologies to calculate capital adequacy ratios. Deposit guarantees may also be extended to all transactional deposits.
- 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 be tightened more, which could result in our downside scenario of a protracted recession lasting eight quarters with total GDP contraction of 1.4%. The current banking sector woes, with significant tightening of lending standards and a withdrawal by regional lenders from commercial real estate financing could cause that outcome, too.

2. Inflation **Neutral**

We keep this at Neutral as we expect continued progress in coming months, encouraged by the noticeable drop in headline inflation thus far in 2023. 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 victorious in their attempts to tame inflation back towards policy targets.

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

We retain this factor at neutral for the time being, acknowledging that risks are skewed to the downside due to the stress faced by regional lenders in the U.S.

4. Valuations **Neutral**

- **Risk-free rates:** 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. We expect spreads to widen if our recession call comes true.
- In **Currencies,** the U.S.$ remains over-valued, but also remains a meaningful absorbent of de-risked investment flows.

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

Speculative bets on S&P 500 remained net short. Retail investor sentiment remained weak. But risk markets look extended based on prices relative to their 50-day and 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 **Defensive from Neutral**

We move our risk stance to defensive vs neutral earlier i.e., preferring an overweight to less risky assets (core bonds over high yield and equities) due to the following:

- While the economy is showing resilience, equity valuations are still expensive (particularly U.S. equities) which should cap market gains unless earnings growth recovers strongly. Similarly, high yield spreads leave limited room for compression.
- Recent banking developments have increased the probability of a tail risk i.e. credit creation could suffer leading to worse outcomes than expected in our base case.

Key risks

- Potential contagion from the regional banking sector woes which leads to a significant slowdown in credit creation by regional banks in the U.S.
- A policy mistake by Central banks in tightening too much in pursuit of inflation control could cause a deeper recession (our downside case).
- The global real estate sector faces a hard landing, led by the office sector which is facing challenges.
- Geopolitical risks worsen, both in the ongoing Russia-Ukraine conflict, and the 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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