Multi-Asset perspectives

Courtesy of Principal Asset Management

May 2023

Macro

- **Economic activity** slowed a tad in May but divergence between manufacturing (weaker) and services (strong) continued. Our Global Manufacturing PMI slid to 48.2. The DM PMI was softer (46.8 from 47.1; both US and Europe were down) while the EM PMI was slightly higher as ex-China readings improved. Breadth remained weak as seventy-three percent of the countries were in contraction. The one-month reading of our Leading Regime Indicator fell to 50.3 due to softer new order data in China, Japan, and Germany, which pulled our 3-mo regime indicator down to 51.9. Global Economic Surprises were in negative zone, with misses across the board. China's reopening momentum lost steam as consumption, industrial and monetary data missed expectations. Global employment trends, however, remained strong. Our Global Inflation surprise indictor stayed negative as misses in continental Europe and China washed-out beats elsewhere.
- **Global financial conditions** tightened. Both short-term and long-term rates rose, asset market volatility moved up, and monetary growth slowed, while the spread component remained stable. Regionally, conditions tightened the most in US, followed by UK where high inflation remained a headache for policymakers. Conditions in China, India and Japan eased.
- **Global inflation** eased to 4.5% yoy in Apr '23 from 4.8% the month prior (the peak was 6.9% in Sep 2022). The decline was driven by EMs (3.4% from 4.2% with China's CPI dropping to 0.1%) while DM inflation was largely stable. Twenty of the twenty-nine countries printed lower readings in a welcome sign for policy makers. A significant distance remains to be traveled before inflation can reach their goals, particularly in developed economies where core inflation is proving to be very sticky, driven by services. On the other hand, market-based inflation measures (U.S. CPI implied by TIPs) have dropped to a range of 2.05%-2.2% for 2, 5 and 10yrs, well within Fed's comfort zone.

Bottom-up

- **Global bottom-up earnings revisions** were mixed. While MSCI AC World's **2023 expected EPS growth** fell to 0% in $ terms, the 3-month change slowed to -1%. Communication services, Cons Discretionary, Industrials and Utilities saw positive revisions while Energy, Materials and Real Estate remained negative. The global 3m Earnings Revisions Ratio for 2023-24 was at 0.44 (44% upgrades, 56% downgrades) vs 0.39 at 12/31/22, confirming signs of bottoming.
- **YTD '23 Global credit rating upgrades to total changes** remained at 43% (43% upgrades, 57% downgrades). Both HY and IG were broadly unchanged at 34% and 61% respectively.

Valuations

- **Global equity valuations remained expensive**. MSCI ACWI has been cheaper than current levels 86% of the time in history. US Large cap, Growth and Taiwan continued to flash red. Other markets were either fair value or cheap.
- **U.S. IG and HY** spreads widened 2bps and 7bps to finish at 128bps and 459bps, 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 3.64% was 136bps above its 10-yr median. However, it was still 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 lost -2% in May 2023 which shrank YTD 2023 return to 4%.
- **Global Equities** had a weird month. Resurging interest in technology stocks, riding the AI theme, saw the tech-heavy NASDAQ jump 6% even as 63% of our universe closed with losses. The median local currency return was -2%. Offshore listed Chinese stocks (-9%) became the worst performing major market for the year due to disappointing growth, lack of a policy response, and continued geopolitical tensions with U.S. which raised worries about continuity of foreign institutional portfolio capital into China. Globally, IT and Consumer Discretionary stocks outperformed while Energy and Materials underperformed. Growth was the winning style, with the large margin putting it in pole position vs Value across multiple time periods.
- **Fixed income**: Our global policy-rate indicator rose to 4.2% with 11 rate hikes. Fed, BOE, and most European banks hiked 25bps each in pursuit of their inflation goals. Our EM policy rate indicator was stable at 4.6%. Our economists expect a 25bp hike in July in the U.S., followed by a long pause, in contrast to market expectations of -75bps of net rate cuts over the next twelve months. Our Global Sovereign 10-yr Yield indicator rose 8bps to 3.95% with 14/29 countries seeing higher yields. The global 2-10 curve spread inverted to -21bps from -19bps, with 17/29 countries still in inversion. The U.S. curve inversion deepened to -76bps.
- **Currencies**: US$ strengthened against 87% of the currencies we track it against (60% in the prior month) as sentiment towards the greenback improved. It strengthened 2.6% against the DM basket while gaining 0.9% against MSCI EM FX.
- **Commodities**: The GS commodity index dropped -6.5%, with all segments lower. Energy and industrial metals were hit harder as weakened Chinese growth outlook cast doubts on the demand story. Brent closed the month at 73$/bbl.

US Housing Indicators

- U.S. home prices went up 0.5% surprisingly in Mar 2023 (20-city Case Schiller index) and are now -4% below their mid-2022 peak. The yoy growth turned negative at -1% for the first time since May'2012. However, the housing adjustment process remains orderly due to strong employment trends, tight vacancy rates and tight lending standards since GFC. 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 new home demand are beginning to find floors, though the mortgage spread over treasury yields remain stubbornly high, which is impacting affordability adversely.
- While new mortgage costs have gone up ~50% due to higher rates, the cost of servicing outstanding mortgages remains low (3.5%) for the US financial system due to a predominant share of fixed rate mortgages taken at low rates.
- While cap rates have not yet found a top, strong demand exists for idiosyncratic properties in residential, industrial and logistics at cap rates below broadly published broad levels. The Office sector, however, remains deeply challenged.

Looking Ahead

1. **Growth** **Neutral (but slightly better at the margin)**
   Macro indicators confirm a slowing but resilient economy, powered by the consumer. 1Q 2023 GDP data releases showed stronger growth than our expectations globally. However, we continue to expect a U.S. recession to start in 4Q 2023 though our outlook has improved at the margin, expressed by an expectation of a two-quarter recession versus three earlier, and a higher probability of occurrence of our upside case. Sticky core inflation and U.S. commercial real estate, which faces significant refinancing challenges in the office sector, could provide the lightning rods for a deeper recession than anticipated in our base case.

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 recognize that core services inflation needs to drop at a much faster pace for headline readings to drop back towards policymaker comfort zones.

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 stresses faced by tightened lending standards in both the U.S. and Euro Area.

4. **Valuations** **Neutral**
   - Risk-free rates: They continue to present meaningful positive yielding anti-fragile alternatives.
   - Equity Valuations remain expensive in the U.S. but are neutral-to-cheap in other markets.
   - 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.$ is over-valued by about 10% based on our models, but also remains the biggest beneficiary 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. **Risk orientation in asset allocation** **Defensive**
   - We retain a defensive stance in asset allocation, preferring less risky assets (high quality bonds over high yield bonds and equities) due to the following:
   - U.S. equity valuations remain expensive, 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

- Contagion from contraction in credit by regional banks which causes a significant slowdown in credit creation in the U.S.
- A policy mistake by Central banks in tightening too much in pursuit of inflation control (our downside case).
- The global real estate sector faces a hard landing, led by the challenged office sector.
- Geopolitical risks worsen, both in the ongoing Russia-Ukraine conflict, and the U.S.-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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