Multi-Asset perspectives

Courtesy of Principal Asset Management

June 2023

Macro

- **Economic activity** continued to show divergence between manufacturing (recessionary) and services (expansionary). Our Global Manufacturing PMI slid to 47.6. The DM PMI softened to 46 from 46.8 (U.S., Europe and Japan were all down), remaining in recessionary zone. A steady China kept the EM PMI near 50. Breadth remained weak as seventy-seven percent of the countries were in contraction. The one-month reading of our Leading Regime Indicator fell to 49.6, its first drop below 50 since Jun'2020 due to softer new orders in China, U.S., and Germany. That pulled the 3-month regime indicator down to 50.5. Global Economic Surprises were negative, as were inflation surprises. Global employment trends, however, remained strong.
- **Global financial conditions** eased. Though both policy rates and yields were higher, their impact was offset by narrower credit spreads, strong equity markets and lower volatility. Regionally, conditions eased the most in U.S., followed by Japan and China. UK, where high inflation remained a headache, saw financial conditions tighten further. Financial conditions are tighter in DMs relative to EMs.
- **Global inflation** eased to 4.1%yoy in May '23 from 4.5% the month prior (the peak was 7% in Sep 2022) with DM inflation (4.7% from 5.3%) staying well above EMs (3.2% from 3.5%). While twenty-four of the twenty-nine countries printed lower readings, significant distance remains to be traveled before inflation can reach policymaker goals in developed economies where core inflation has been sticky, driven by services. On the other hand, market-based inflation measures (U.S. CPI implied by TIPs) remain anchored within Fed's comfort zone of 2.1%-2.3%.

Bottom-up

- **Global bottom-up earnings** revisions were stable. The 2023 expected **EPS growth** for MSCI AC World remained at 0% in $ terms., with 2024 at 11%. The 3-month change slowed to -2%, impacted by translation effects. Communication services and Utilities saw positive revisions while other sectors were negative. The global 3m Earnings Revisions Ratio for 2023-24 was steady at 0.45 (45% upgrades, 55% downgrades) vs 0.39 at Dec 2022, confirming signs of bottoming.
- **YTD '23 Global credit rating upgrades to total changes** edged up to 44% (44% upgrades, 56% downgrades) driven by IG (63% from 61%) while HY remained stable at 34%.

Valuations

- **Global equity valuations started getting stretched**. MSCI ACWI has been cheaper than current levels 89% of the time in history. U.S. Large cap, Growth, Taiwan, and India continued to flash red. Japan's valuation rerating has been the most prominent since the start of the year – it not only moved out of the green zone, it is fast approaching the red one.

- **U.S. IG and HY** spreads narrowed 14bps and 69bps to finish at 114bps and 390bps, respectively. However, they moved to fair value based on our fundamental models due to better macro-economic data. On the other hand, they remained expensive based on the market-based fair value models that are based off market volatility and commodity price change.
- The **U.S. 10-yr treasury yield**, at 3.84% was 155bps above its 10-yr median but moved into the fair value zone of 3.7%-4.5% implied by our UST fair value model.

Markets

- **Multi-Assets**: Our global multi-asset index returned 3% in Jun 2023 which took YTD 2023 return to 7%. All asset classes delivered positive returns barring sovereign bonds which were weighed down by higher bond yields.
- **Global Equities** had a strong month as the tech rally broadened. While the AI theme kept technology stocks in good stead (NASDAQ 6.6%), value and small caps also delivered strong returns, though they remained well behind growth and large caps in the YTD return tables in developed economies. The median local currency return for the month was 3% with 83% of the markets recording gains. Chinese equities rebounded as hopes for a fresh stimulus and thawing of geo-political tensions with U.S. rose. Globally, consumer discretionary, and industrial stocks outperformed while real estate and utilities underperformed. Minimum volatility underperformed as a style.
- **Fixed income**: Our global policy-rate indicator rose to 4.5% with 9 rate hikes. While the Fed paused in June, BOE, European central banks, RBA and BOC hiked to quell persistent inflation. Our economists expect the Fed to hike 25bps in Jul 2023, followed by a long pause. The market pricing too has moved away from rate cuts in 2023. Our Global Sovereign 10-yr Yield indicator fell 4bps to 4.04%, with DM yields rising 15bps to 3.3%. The global 2-10 spread curve inversion deepened to -44bps from -24bps as the U.S. curve inverted to a multi-year high of -106bps. Credit spreads compressed globally.
- **Currencies**: US$ weakened against 63% of the currencies we track it against (13% in the prior month). It weakened -1.4% against the DM basket and -0.3% against EMs based on MSCI EM FX Index. JPY and CNY weakened the most against USD among major currencies.
- **Commodities**: The GS commodity index rose 2.3%, with energy gains outweighing losses in agriculture and precious metals. Industrial metals were flat. Brent closed the month at 75$/bbl.

US Housing Indicators

- The Federal Housing Finance Agency's U.S. home price index (purchases only, seasonally adjusted) increased 0.7% in Apr 2023 to a new high though its annual growth dropped to 3%. In contrast to the stressed office sector, the housing sector has weathered the interest rate storm well despite new mortgage costs implying a 50% increase in monthly EMIs just due to higher rates (7% vs 3.25%).
- New Home Sales have bounced despite weak housing affordability (buyers could be increasingly using cash savings to buy homes). NAHB's Housing Market Index rose to an eleven-month high of 55 from 50 (>50 indicates positive expectations). All components i.e., current sales, buyer traffic and future expectations touched 11-month highs.
- U.S. national rental vacancy rate remains low though it has ticked up from the tights of 3Q 2022.
- The cost of servicing outstanding mortgages remains low (3.55%) for the U.S. 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

- **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 global growth than our expectations. Though we continue to expect a U.S. recession to start in 4Q 2023, our outlook has improved at the margin, expressed through expectation of a two-quarter recession versus three, and a higher probability of occurrence of the upside case (non-recessionary). In the upside case, we could see recession impact two key sectors i.e., manufacturing, and commercial real estate (particularly the office sector) while the broader economy continues to grow, albeit below trend.

- **Inflation** **Neutral**
  We retain this factor at Neutral. While headline inflation has dropped off appreciably, sticky core services inflation implies an uneasy path from current levels to policymaker goals. Structurally, there are aspects (the greenification premium which will make conventional sources of energy more expensive, adverse demographics i.e., peaking of China's working age population, re-jigging of global supply chains for greater geopolitical security, and peak globalization, which is gradually returning pricing power to companies) that point towards greater inflation in the next decade vs. the pre-COVID one; though developed economy Central banks have so far expressed the belief that inflation can be sustainably brought down towards their 2% goal using monetary tools without compromising growth.

- **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 caused by tightened lending standards in both the U.S. and Euro Area.

- **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 at fair value on our fundamental fair value but tight on our 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 valuation models.

- **Technicals** **Negative from Neutral**
  Speculative bets on S&P 500 remained net short but at a lower level. Retail investor sentiment jumped, with AAII Bull-Bear spread turning positive at 14 after fourteen successive months of negative readings. Price momentum for riskier assets looks extended based on current prices relative to 50-day and 200-day moving averages; the equity indices looking particularly extended are U.S., Growth, and Japan. Hedging implied by the put/call ratio dropped below long-term averages. Overall, we downgrade this this factor from neutral to negative.

- **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.
  - The U.S. yield curve (2-10yr treasury spread) remains deeply negative, which keeps recession probability extremely high. Though the regional bank stress that engulfed markets earlier this year is abating, its scars on growth through constrained credit creation should be evident by the end of the year, just when we expect the U.S. consumers to run out of steam, having exhausted bulk of their pandemic era excess savings.

Key risks

- Contagion from credit contraction by regional banks causes a significant tightening of U.S. financial conditions.
- 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, either in the ongoing Russia-Ukraine conflict, or the U.S.-China relationship, or both.
- Tax rates rise globally as governments try to flatten the income curve.

Risk considerations
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