Multi-Asset perspectives

Courtesy of Principal Asset Management

July 2023

Macro

- **Economic activity** continued to diverge between manufacturing (recessionary) and services (strong, with PAA Global Services PMI at 53.7 for Jun'23). However, manufacturing showed signs of hitting the trough with our Global Manufacturing PMI edging up 0.20 to 47.8. The DM PMI was flat at 46 (U.S. was higher but remained well below 50, while Europe and Japan contracted further), remaining in recessionary zone. Improvements in China, Korea, Brazil, and Indonesia helped EM PMI to rebound to 50.4. However, the breadth remained weak with 77% of the countries in contraction. While the three-month reading of our Leading Regime Indicator stayed near the contractionary zone, the one-month reading edged up to 50.1. Economic Surprises were negative barring China. Global employment trends remained strong.
- **Global financial conditions** were stable despite higher rates and slower monetary growth as credit spreads tightened. They tightened a little in Europe while easing a little in EMs (China and India).
- **Global inflation** eased to 3.6%yoy in June'23 from 4.1% the month prior (the peak was 7% in Sep 2022) with DM inflation (4.1% from 4.7%) staying well above EMs (3.0% from 3.2%). While twenty-five of the twenty-nine countries printed lower readings, significant distance remains to be traveled before inflation can reach policymaker goals on core inflation in developed economies. Market-based inflation measures (U.S. CPI implied by TIPs) remain anchored within Fed's comfort zone @ 2.1% for 2 years though 5 & 10yr break-evens edged into the 2.3-2.4% range.

Bottom-up

- **Global bottom-up earnings revisions** were stable. The **expected EPS growth** for MSCI AC World remained at 0% and 11% in $ terms for 2023 and 2024. The 3-month change was marginally negative at -1%. Communication services, Consumer Discretionary and Utilities saw positive revisions while other sectors were either flat or negative. The global **3m Earnings Revisions Ratio** edged up to 0.46 (46% upgrades, 54% downgrades). It was at 0.39 as of Dec 2022.
- **YTD'23 Global credit rating upgrades to total changes** edged up to 45% (45% upgrades, 55% downgrades) driven by IG (66% from 63%) while HY remained stable at 34%.

Valuations

- **Global equity valuations got even more stretched.** MSCI ACWI was cheaper than current levels 89% of the time in history. U.S. Large cap, Growth, Taiwan, Thailand, and India continued to flash red while Japan got close to the red zone. Latin America and parts of south Asia remained cheap.
- **U.S. IG and HY spreads** narrowed 10bps and 23bps to finish at 104bps and 367bps, respectively. They remained expensive based on our fair value models.
- The **U.S. 10-yr treasury yield**, at 3.96% was 167bps above its 10-yr median but just below its fair value zone of 4.1%-4.9% implied by our UST fair value model.

Markets

- **Multi-Assets**: Our global multi-asset index returned 3% in Jul 2023 which took YTD 2023 return to 10%. All asset classes delivered positive returns during the month.
- **Global Equities** had a strong month as the tech rally broadened further. Even as NASDAQ (4%) continued its rise, value and small caps also delivered strong returns though they lagged growth and large cap in the YTD return tables in developed economies. The median local currency return for the month was 3% with 95% of the markets recording gains. Signs of a policy pivot to focus on growth and thawing of geo-political tensions with U.S. triggered a strong rebound in Chinese stocks. Globally, Energy, Materials, Communication Services and Financials outperformed. Small caps beat large caps. Minimum volatility struggled globally.
- **Fixed income**: Six rate hikes took our global policy-rate indicator to 4.6%. The Fed resumed hiking after a pause as we expected. The market is pricing no change in U.S. policy rate in 2023 and five cuts in 2024. ECB and BOC also hiked in pursuit of their inflation goal. Our Global Sovereign 10-yr yield indicator rose 9bps to 4.1%, with DM yields rising 11bps to 3.4%. The global 2-10 spread curve ended steeper at -30bps from -44bps with US ending at -92bps from -106bps. Credit spreads compressed globally as markets moved further towards a non-recessionary outcome.
- **Currencies**: The US$ weakened against 73% of the currencies we track it against (63% in the prior month). It weakened -1.0% against the DM basket and -1.6% against EMs based on MSCI EM FX Index. The Norwegian Krone strengthened the most against US$ among major currencies, helped by recovering oil prices.
- **Commodities**: The GS commodity index rose 9.8%, as all sectors recorded gains. Energy led the charge with brent crude gaining 16% to close at $86/bbl.

US Housing Indicators

- US home prices are stabilizing as the huge gap between new mortgages costing 7% and the average rate on outstanding mortgages of 3.6% is creating a high mortgage bar for owners of existing homes to flood markets with offers to sell. Indeed, the MSCI Residential REITs index is up 10% this year reflecting improved optimism on the housing sector. However, Office REITs, which have underperformed the broader REITs complex since 2016, continue to struggle and are down -11% in absolute terms.
- U.S. national housing rental vacancy rate remains low though it has ticked up from the tights of 3Q 2022.
- 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 challenged.

Looking Ahead

- **Growth** **Neutral (but better at the margin)**
  Macro indicators confirm a resilient economy, powered by the consumer and strong employment. 2Q 2023 U.S. GDP grew stronger than expectations at 2.6% yoy, 2.4% QoQ annualized, powered by private investments. Consumer spending growth slowed to 1.6% but remained robust. While our last call was for a mild recession starting in 4Q 2023, we acknowledge that the economy has weathered the higher interest rate storm better than our initial expectations. Having said that, we are also conscious that tighter financial conditions and yield curve inversion take 18-24 months to play out and we have not crossed the danger zone yet. In the best-case scenario, while the broader economy scrapes through without shrinking, manufacturing, and commercial real estate (particularly office) experience recessionary conditions.

- **Inflation** **Neutral**
  We retain this factor at Neutral. While headline inflation has dropped off appreciably, sticky core services inflation keeps us guarded. Structurally, there are some aspects (the greenification premium which will make energy from conventional sources more expensive, peaking of China's working age population, rejigging of global supply chains for greater geopolitical security, and peak globalization) that point towards greater inflation in the next decade vs. the pre-COVID one; though developed economy Central banks remain confident that inflation will be brought down towards their 2% goal. It remains to be seen if they keep policy tight to force demand to adjust lower or accept higher inflation.

- **Global financial conditions** **Neutral**
  We retain this factor at neutral while acknowledging that risks are skewed to the downside due to 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 several other markets.
  - Corporate spreads are near fair value on our fundamental fair value models but remain tight when we add market-based factors to our fundamental models. They should widen from here unless the U.S. economy manages to avoid a recession.
  - In Currencies, the U.S.$ is over-valued by about 10% based on our valuation models.

- **Technicals** **Negative**
  Speculative shorts on S&P 500 were reduced. Retail investor sentiment jumped, with AAII Bull-Bear spread strengthening to 21 from 14. Price momentum for riskier assets is very extended based on current prices relative to 50-day and 200-day moving averages Overall, we keep this factor at 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 valuation remains expensive, which should cap market gains unless earnings growth recovers strongly. Similarly, high yield spread leaves limited room for compression.
  - The U.S. yield curve (2-10yr treasury spread) remains deeply negative, which keeps recession probability high. Though the regional bank stress that engulfed markets earlier this year has abated, lending standards remain tight, and banks may have to hold higher regulatory capital which could restrain credit creation at a time consumers have exhausted bulk of their pandemic era excess savings.

Key risks

- Contagion from credit contraction by 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.
- 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

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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