Multi-Asset perspectives

Courtesy of Principal Asset Management

September 2023

Macro

- **Economic divergence** between manufacturing (recessionary but recovered to 48.8 from 48.3) and services (strong but losing momentum) narrowed. DM Mfg PMI rose to 47.3 (U.S. 49 from 47.6, Europe 44.3 from 43.8, and Japan 48.5 from 49.6). EM Mfg PMI stayed above DM at 51.0 (China's ticked up to 50.2). Overall breadth, however, remained weak with 77% of the countries still in contraction. Our Leading Regime Indicator softened a tad but stayed in a neutral zone. Economic Surprises remained negative barring China which eeked out a modest positive surprise. Global employment trends remained strong, which is presenting policy headaches for central banks.
- **Global financial conditions** tightened on higher yields, wider spreads, and lower equities. Almost all the tightening took place in the U.S. while ex-U.S. financial conditions were cushioned by weaker exchange rates and lower rates in Latin America.
- **Global inflation** ticked up to 4.1% yoy in Aug '23 (the peak was 7% in Sept '22) with DM inflation (4.3% from 4.2%) staying above EMs (3.9% from 3.3%). Almost half the countries saw higher inflation, caused largely by rising petroleum prices even as core readings edged lower. Significant distance remains to be traveled before inflation can reach developed economy policymaker goals. Market-based inflation measures (U.S. CPI implied by TIPs) remain anchored within Fed's comfort zone in the 2-2.5% range, though they did move up about 10bps last month.

Bottom-up

- **Global bottom-up earnings revisions** turned soft. The expected EPS growth for MSCI AC World dropped to -2% from 0% for 2023 but stayed unchanged at 11% for 2024. The 3-month change remained slightly negative. Consumer discretionary and utilities lead in positive earnings revisions while materials and real estate were at the bottom. The global 3m Earnings Revisions Ratio stayed flat at 0.46 (46% upgrades, 54% downgrades) versus 0.39 as of Dec '22.
- YTD '23 **Global credit rating upgrades** to total changes edged up to 42% (42/58 upgrade/downgrade ratio). IG improved to 65% from 63% (both U.S. and Europe improved). Global HY was stable at 34%.

Valuations

- **Global equity valuations remained stretched despite the correction in August-September**. MSCI ACWI was cheaper than current levels 86% of the time in history. U.S. Large cap, Growth, Value, Taiwan, Thailand, and India continued to flash red (expensive). Latin America and parts of south Asia remained cheap.
- **U.S. IG spread widened 3bps to 121bps and HY spread 22bps to 394bps**. While they cheapened incrementally, they remained on the expensive side versus our model-implied fair values. However, they remain in the median zone versus their long-term history.

- The **U.S. 10-yr treasury** yield, at 4.57% was 228bps above its 10-yr median but within the fair value zone of 4.4%-5.2% implied by our UST fair value model.

Markets

- **Multi-Assets**: Our global multi-asset index returned -3% in Sept '23 which shrank YTD 2023 return to 5%. All asset classes barring commodities delivered negative returns for a second successive month. Adverse seasonality effects associated with the month of September may have played a hand (it was the 4th successive negative September for U.S. Equities, and 7th successive for U.S. bonds).
- **Global Equities** corrected due to valuation challenges, repricing of interest rates (higher for longer) and the jump in oil prices which could dent consumer discretionary spending heading into next year. DM equities (-4.3%) trailed EMs (-2.6%), as monetary and fiscal easing in China curtailed losses in a market that has struggled all year. U.S. equities dropped around -5%. 33 of the 41 markets we track ended with losses. Of the eight that gained, Turkey (5%) was the best. The median local currency return was -2.9% which shrank YTD 2023 median return to 5.5%. Value outperformed as a Style, followed by low volatility. Energy was the clear winner among sectors, followed by financials.
- **Fixed income**: Seven rate hikes and four cuts raised our global policy-rate indicator to 4.9%. While European banks (ECB, Sweden, Norway, Denmark) dominated hikes, Latin American banks (Chile, Brazil, Peru) dominated cuts. The bigger story, though lay in sovereign bond yields where the curves bear steepened meaningfully yet again. Our Global Sovereign 10-yr yield indicator jumped 30bps to 4.5%, with DM yields rising 39bps to 3.9% and EM yields 18bps to 5.2%. Muted increases in 2-yr yields steepened the global 2-10yr yield curve to -11bps from -26bps (U.S. to -47bps from -75bps) as markets priced in higher neutral rates. Indeed, the Fed itself expects fewer rate cuts in 2024 than it did earlier and is likely to revise its expectation of long-run neutral Fed Funds rate higher from 2.5%. Credit spreads were broadly unchanged in IG but widened a tad in High Yield. The jump in yields made it a month of negative return for almost all types of fixed income investors barring short-term money market type funds. 20-30yr U.S. Treasurys suffered the most (-7%).
- **Currencies**: Risk-off conditions and rising carry differentials made it yet another strong month for the U.S. dollar. It appreciated against 80% of the currencies we track it against (93% the prior month), strengthening 2.5% against DMs and 1% against EMs.
- **Commodities**: The GS commodity index rose 3% as energy prices (6%) took another leg higher on continued tightness engineered by OPEC-Russia amidst robust global demand. The recovery of U.S. crude output to pre-pandemic highs of 13mbpd did not help. The energy sub-component has risen 24% over the past three months, with Nymex up 29%, Brent 27% and U.S. natural gas 5%.

US Housing Indicators

- U.S. home prices edged up yet again on robust demand for new homes, funded largely by savings. The FHFA new purchase index was up 4.6% yoy while the 20-city Case-Schiller Index clawed back earlier losses to close July '23 unchanged versus 2022. Buyers are having to make do with limited offers as high mortgage rates (7.75% for a 30-yr mortgage) act as a strong disincentive for existing owners to churn. While new mortgage rates are at multi-year highs, the effective interest rate on the stock of outstanding mortgages remains low at 3.6%, up 30bps from 2022 lows, implying limited macro risks. While macro risks are contained, further increases in yields could start capping price gains.
- Weak affordability kept the U.S. rental markets tight, with vacancy rates near multi-year lows. Rent growth, though, has started stalling due to an increase in supply of rental units.
- While cap rates are yet to find a top, strong demand continues to exist for idiosyncratic properties in industrial, residential, and logistics at cap rates well below broadly published broad levels. The Office sector, however, continues to struggle.

Looking Ahead

- **Growth** **Neutral (improving at the margin)**
  Macro indicators confirm a resilient U.S. economy, powered by the consumer and strong employment. Revised 2Q '23 U.S. GDP was unchanged at 2.1% QoQ annualized, powered by business investments and net exports even as consumption growth got chopped from 1.7% to 0.8%. Longer term revisions showed annual GDP higher by one-tenth of a percent in each of the past five years. Savings trends showed a lower rate of savings heading into the pandemic but a higher savings rate since, implying a larger buffer with savers than initially thought of. Our economists expect the U.S. economy to stall for a couple of quarters into the middle of next year, followed by a recovery towards trend. Outside of the U.S., we expect European growth to remain weak. China's growth should recover after a disastrous 2nd quarter, but structural challenges imply a trend growth in the 4% area in the coming few years. Looking beyond China, India, Brazil, and Mexico continue to grow faster than our expectations in the emerging world.

- **Inflation** **Neutral**
  While inflation has dropped appreciably over the past several months, strong employment growth and rising commodity prices imply more distance needs to be traveled before policymakers can declare victory over inflation. From a longer- term perspective, the move towards cleaner sources of energy will keep energy costs elevated, which combined with a peaking of China's working age population, rejigging of global supply chains for greater geopolitical security, expansionary fiscal policies, and peak globalization, will continue to challenge policymakers' ability to bring inflation sustainably towards the 2% goal in developed economies, particularly the U.S.

- **Global financial conditions** **Neutral**
  The market repricing of forward rates (un-inversion of yield curves) is putting pressure at the long end, pushing up risk premiums. Though scope for further increases appears limited as long bond yields are better valued than before, there exist risks that developed economy central banks keep tightening conditions until they see a visible growth impact.

- **Valuations** **Neutral**
  - Risk-free rates: continue to present meaningful positive yielding anti-fragile alternatives.
  - Equity Valuations remain expensive in the U.S. but are cheap in Asia and Latin America.
  - Corporate spreads are expensive, leaving little room for further compression.
  - In Currencies, the U.S. Dollar is over-valued between 10-15% based on our valuation models.

- **Technicals** **Neutral from Negative**
  Speculative shorts on U.S. treasury futures remained at an all-time high. Oil longs were added at a fast pace. S&P 500 shorts were reduced, however. Retail investor sentiment weakened with the AAII Bull-Bear spread dropping to -13 from -1. Recent correction has weakened overbought price momentum indicators for riskier assets using both 50-day and 200-day moving averages. Hedging through put options was just above median levels. Overall, while the market is not in the overbought zone anymore, it has not entered the oversold territory either.

- **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:
  - Risk premiums remain low relative to risk-free rates. U.S. equity valuation remains expensive, which will keep challenging returns in the face of higher bond yields. Similarly, tight high yield spreads leave little room for compression.
  - The extreme short positioning in treasuries supports defensive assets from a technical perspective though seasonality effects tend to favor higher yields in the 4th quarter.

Key risks

- Policy mistakes by Central banks in tightening too much.
- Credit contraction by banks causes further significant tightening of U.S. and global financial conditions.
- 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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