Multi-Asset perspectives

Courtesy of Principal Asset Management

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Macro

- **Manufacturing strength seen in the past few months** lost some momentum as our global Manufacturing PMI slid -1.2 points to 47.7, dragged by weaker readings in U.S., China, and Europe. Our DM Mfg PMI slid further into contractionary territory at 45.9. The EM PMI stayed in modest expansion at 50.3. However, our Leading Regime Indicator edged up to 51.1, helped by a recovery in new orders in most industrialized nations. A sustained recovery in new orders will help the PMI index in coming months. Global Economic Surprises remained negative though the U.S. moved to neutral after six straight months of negative readings. Global employment trends remained strong, which continues to present policy headaches for central banks in developed economies.
- **Global financial conditions** tightened on higher yields, wider spreads, and slower monetary growth, with most of the tightening taking place in the U.S. as has been the case all this year.
- **Global inflation** ticked down to 3.9% yoy in Sep ’23 (the peak was 7% in Sep ’22) with DM inflation at 4% from 4.2%, and EMs at 3.7% from 3.9%. 60% of the countries saw lower inflation. Significant distance remains to be traveled before inflation can reach developed economy policymaker goals. Market-based inflation measures (U.S. CPI implied by TIPs) remained within the Fed’s comfort zone of 2-2.5%, though they did increase 10-15bps last month.

Bottom-up

- **Global bottom-up earnings** revisions were largely unchanged. The **expected EPS growth** for MSCI AC World was -2% for 2023, and 11% for 2024. The 3-month change was at -1%. Energy and consumer discretionary earnings were revised up the most, while materials and real estate continued to see cuts. The global 3m Earnings Revisions Ratio was stable at 0.45 (45% upgrades, 55% downgrades) versus 0.39 as of Dec ’22.
- **YTD ’23 Global credit rating upgrades to total changes** was almost unchanged at 45% (45/55 upgrade/downgrade ratio). IG eased to 62% from 65%. Global HY was stable at 35%.

Valuations

- **Global equity valuations remained stretched despite shedding some froth in the past quarter**. MSCI ACWI was cheaper than current levels 80% of the time in history (86% the month prior), driven largely by expensive U.S. stocks (Large cap and Growth). US Small and mid-caps, however, turned very cheap. Latin America and most parts of Asia were cheap too.

- **U.S. IG spread widened 8bps to 129bps and HY spread 43bps to 437bps**. While they cheapened incrementally, they remained on the expensive side versus our model-implied fair values. 30-yr U.S. corporate spreads remained near their long-term median.
- **The U.S. 10-yr treasury yield, at 4.93% was 264bps above its 10-yr median** but in the fair value zone of 4.5%-5.5% implied by our UST fair value models.

Markets

- **Multi-Assets**: Our global multi-asset index returned -2% in Oct 2023 which shrank YTD 2023 return to a meager 3%. All asset classes delivered negative returns as markets adjusted to higher long-term yields in the U.S.

- **Global Equities** corrected due to valuation challenges, repricing of interest rates (higher for longer) and further unwind of the price momentum that had been built through the course of this year. DM equities (-2.9%) outperformed EMs (-3.9%). The global market capitalization dropped to $99 trillion and has lost about -11% from its 52-week high in July. 33 of the 41 markets we track ended with losses. Of the eight that gained, Poland (10%) was the best. U.S. small caps were among the worst with a return of -7% (-17% last 3 months). The median local currency return was -3.4% which shrank YTD 2023 median return to just 1.9%. Low volatility outperformed, followed by Quality. IT outperformed. Energy performed the worst on weak crude oil prices, following a strong showing in the month prior.

- **Fixed income**: Four rate hikes and four cuts made it the first month since Feb 2021 when hikes did not outpace cuts! All the action was in the EM part of the world, as DM central banks took a breather. Recent rate moves imply that at 5%, our global policy-rate indicator is very close to its cyclical peak. Sovereign bond yields, however, continued their bear steepening ascent. Our Global Sovereign 10-yr yield indicator rose 16bps to 4.6%, with DM yields rising 23bps to 4.1% and EM yields 7bps to 5.3%. Muted increases in 2-yr yields steepened the global 2-10yr yield curve to 2bps from -11bps (U.S. to -16bps from -47bps, +76bps in the last 3 months) as markets kept pricing higher neutral rates. Credit spreads were generally wider, far more in High Yield than in Investment Grade. A combination of higher yields and wider spreads made it another month of negative return for almost all types of fixed income investors barring short-term money market type and floating rate strategies. 20-30yr U.S. treasuries continued to bleed, losing -5% for the month (-14% last 3 months).

- **Currencies**: Risk-off conditions and rising carry differentials made it yet another strong month for the U.S. dollar. It appreciated against 70% of the currencies we track it against (versus 100% of currencies in the last 3 months), strengthening 1% against DMs. Moves against EMs were muted though. JPY, after another month of depreciation, retained its position as the cheapest currency on purchasing power parity, followed by the Swedish Krona. The U.S. dollar was the most expensive.

- **Commodities**: The GS commodity index dropped -5% as energy prices (-9%) tumbled after rising about 30% in a prior 4-month period due to tightness engineered by OPEC-Russia. Developments in Israel have the potential to push prices significantly higher, should the conflict spread to the oil producing part of the Middle East which starts constraining supplies. Precious metal prices caught a bid during the month (6%) as anti-fragile plays in an environment of heightened geo-political risks.

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 5.6% yoy while the 20-city Case-Schiller Index rose 2.2% yoy in Aug 2023. Buyers are having to make do with limited offers as high mortgage rates (around 8% for a 30-yr mortgage) continue to act as a strong disincentive for existing owners to churn, which also explains the very low level of activity in existing homes. While the effective interest rate on the stock of outstanding mortgages remains low at 3.75%, it has edged up 45bps from 2022 lows and will edge higher as new mortgages replace old ones, and rates reset higher on floating ones.

- 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 residential units. Office rents, on the other hand, continue to soften, particularly for older properties with dropping occupancy levels.

- While cap rates are yet to find a top, strong demand still exists for idiosyncratic properties in industrial, residential, and logistics at cap rates well below broadly published levels. The Office sector, however, continues to struggle.

Looking Ahead

- **Growth** **Neutral**
  Macro indicators confirm a resilient U.S. economy, powered by the consumer and strong employment. Initial estimate for 3Q '23 U.S. GDP was strong at 4.9% QoQ annualized vs 2.1% in 2Q 2023, powered by strong consumer spending (4%), private investment (8.4% with a large contribution from inventory accumulation, which should reverse in coming quarters), and Government consumption (4.6%). While the growth was way above trend, we expect 4Q 2023 to start a soft patch, which would culminate in stall speed growth by the middle of next year. Outside of the U.S., we expect European growth to remain weak. China's growth should recover given concerted recent efforts by policymakers to shore up sentiment, but structural challenges imply that the rebound is likely to be short-lived. 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 implies more distance needs to be traveled before policymakers can declare victory. 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 in 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 end up over tightening conditions.

- **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 most other parts of the world.
  - Corporate spreads are on the expensive side, leaving little room for further compression.
  - Among Currencies, the U.S. Dollar is over-valued between 10-15% based on our valuation models.

- **Technicals** **Neutral (moving towards Positive)**

  Speculative longs increased in both gold and oil due to the Israel-Hamas situation. U.S. dollar net longs were higher too. Net shorts in U.S. treasury futures remained near an all-time high. S&P 500 shorts were reduced, however. Retail investor sentiment remained negative with the AAII Bull-Bear spread at -14. The recent correction has weakened overbought price momentum indicators for riskier assets using both 50-day and 200-day moving averages considerably. Hedging through put options moved a tad above its median level. Overall, while the market is not yet into oversold territory, another month of correction would put it there.

- **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) as risk premiums remain low relative to risk-free rates despite an uptick in recent months. U.S. equity valuation remains expensive, which will keep challenging returns in the face of higher bond yields. Similarly, the high yield spread is not wide enough yet to offer outsized returns.

Key risks

- Policy mistakes by Central banks in tightening too much.
- The global real estate sector faces a hard landing, led by the challenged office sector.
- Geopolitical risks worsen relating to the Israel-Hamas conflict or the ongoing fight between Russia and Ukraine. On the other hand, the frosty U.S.-China relationship seems to be thawing at the margin, with President Xi and President Biden making efforts to meet each other shortly.
- Tax rates rise globally as governments try to flatten the income curve.

Risk considerations
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