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Multi-Asset perspectives

Courtesy of Principal Asset Management

December 2023

Macro

- **Manufacturing indicators were broadly stable.** Our global Manufacturing PMI was stable at 48, with US (47.4 ↑), China (49 ↓) balancing each other out. Europe (45) was unchanged. EM PMI (50.1) stayed above DM PMI (46.6). Our Leading Regime Indicator just stayed on the expansionary side, ticking up marginally. Global Economic Surprises turned slightly positive with contributions from Europe and Japan. Global employment trends remained strong, continuing to drive consumption.
- **Global financial conditions** continued to ease due to sharply lower yields and tighter spreads. Strong equity markets helped too. U.S. financial conditions eased the most (-0.9 from -1.1). Fed speakers fueled fire to market expectations of aggressive rate cuts starting in 1H' 24.
- **Global inflation** continued to slide lower, reaching 3.2%yoy in Nov '23 (the peak was 7% in Sep '22) with DM inflation at 2.9% and EMs at 3.5%. 75% of the countries saw lower inflation. Recent progress on inflation has been encouraging though some more distance must be traveled to reach developed economy policymaker goals. Market-based inflation measures (U.S. CPI implied by TIPs) were stable and comfortably within the Fed's comfort zone of 2-2.5%.

Bottom-up

- **Global bottom-up earnings revisions** were stable. The expected EPS growth for MSCI AC World was 0% for 2023, and 10% for 2024. The 3m Earnings Revisions Ratio was slightly weaker at 0.42 (42% upgrades, 58% downgrades) versus 0.44 the month prior. Between the start and end of 2023, EPS was revised up the most for consumer discretionary (6%) and revised down the most for materials (-22%) and energy (-14%).
- **YTD '23 Global credit rating upgrades to total changes** was marginally weaker at 43% (43/57 upgrade/downgrade ratio). IG eased to 58% from 60% (peak was 66% in Jul '23). Global HY remained at 35%, a level it has held since mid-2023.

Valuations

- **Global equity valuations moved further to the expensive side after the strong December rally**. MSCI ACWI was cheaper than current levels 90% of the time in history (90% the month prior), driven by expensive U.S. stocks (Large caps). US small caps, however, remained cheap. Latin America and most parts of Asia remained cheap too.
- **U.S. IG spread narrowed -5bps to 99bps (37th %ile in history) and HY spread -47bps to 323bps (16th %ile in history**). Though our fair-value model implied values came in too, spreads remained expensive, and are baking in a perfect blue-sky scenario of lower rates, lower inflation and continued economic expansion. 30-yr U.S. corporate spreads ended well inside their long-term medians.
- **The U.S. 10-yr treasury yield**, at 3.9% was just below the lower end of our model implied fair value range of 4.2%-5%**.**

Markets

- **Multi-Assets**: Our global multi-asset index returned 4% in Dec '23 which expanded 2023 return to 14% (-16% in 2022). Both equities and fixed income had another great month, influenced by lower inflation, lower rates and continued economic growth. The strong recovery dealt a hammer blow to those predicting the demise of the traditional 60:40 portfolio.
- **Global Equities** had another strong month, powered by the same themes (lower inflation, easier financial conditions, continued economic growth) that had caused a pronounced jump in equities in Nov '23. While growth indicators remained stable, markets took increasing comfort that easing financial conditions would limit the growth damage, should there be a slowdown next year. DM equities (5%) outperformed EMs slightly (4%), with the latter dragged down by weak performance in the China complex yet again. 34 of the 41 markets we track ended with gains, with U.S. small caps (12%) outperforming other large markets. The median local currency return was 3% which expanded 2023 median return to 17%. Quality and value outperformed, though growth beat value by a huge margin in the U.S. for the full year. IT and consumer discretionary (both have large exposure to growth factors) outperformed other sectors handsomely for the full year. Energy, the winner of 2022, struggled as oil prices failed to sustain the lofty gains of 2021-22. The global market capitalization jumped to $111trillion, its highest this year but -8% below the Dec '21 level. Talking of markets that completely recouped their 2022 drawdowns, Brazil (128% of 2021 close) and India (124%) were big winners among large markets. Offshore China stocks were huge underperformers (69% of 2021 close). U.S. small caps (90%) and Nasdaq (96%) also could not recover their 2022 drops fully.
- **Fixed income**: Six rate cuts and three hikes made it a second successive since Feb '21 when cuts exceeded hikes. With DM policy rates at 4.5%, there exists room for meaningful cuts in 2024. Lower inflation and an absence of pushback from Central banks against dovish market moves, pushed our Global Sovereign 10-yr yield indicator down by -33bps (-73bps in two months) to 3.95% (-33bps vs Dec '22). The entire yield curve shifted down, keeping the global 2-10yr term spread stable at -13bps (U.S. was at -37bps). Credit spreads compressed sharply, with High Yield leading the way (-146bps for the year). Lower yields and tighter spreads made it a strong month and year for fixed income investors. 20-30yr U.S. treasuries jumped 9% to close the year in positive terrain but they lagged every other fixed income asset class.
- **Currencies**: Risk-on conditions and lower carry differentials (U.S. rate cuts are likely to exceed other regions) made it another weak month for the U.S. dollar. It depreciated against 80% of the currencies we track it against, weakening -2% against DMs (DXY Index) and -1% against EMs (MSCI EM Currency Index). For the full year, it dropped -2% against DMs and -5% against EMs in a sharp reversal of fortunes from 2022 when the greenback was the undisputed winner. JPY retained its position as the cheapest currency on purchasing power parity, followed by the Turkish Lira. The U.S. dollar was 10% overvalued.
- **Commodities**: The GS commodity index had its third successive negative month, dropping -4% (-12% over both 3 and 12 months) as energy prices (-6% for the month, -15% for the year) tumbled further as signs of fissures in OPEC's supply model were confirmed at a time when U.S. oil output remained at an all-time high (13.2mbpd). Precious metals paused after two strong months but closed as the best performing sub-sector within commodities for the year (12%).

US Housing Indicators

- U.S. home prices edged up yet again. The 20-city Case Schiller index increased 4.9%yoy, and the FHFA house price index 6.3%yoy in Oct ’23. Home purchases remain supported by savings given high mortgage rates. Lower mortgage rates could paradoxically cause prices to either stabilize or even soften marginally by encouraging more supply into the market. Supply is currently constrained by high refinancing cost. For reference, between 2021 and 2023, 30-yr fixed rate mortgage rose 375bps, and median home sale price rose 10%. Combining the two, the monthly mortgage servicing cost jumped 68% (EMI of $1,000 jumped to $1,680), which explains why homeowners are reluctant to offer homes for sale.
- Lower mortgage rates caused Housing affordability to ease a bit last month, more help is needed for activity to get back to 2021 levels. For context, if personal disposable incomes rose 5%, home prices and mortgage rates dropped -5% and
- -100bps respectively, the affordability index would recover 30% to 75, which would still be 20% worse than its long-term average. Having said that, strong household balance sheets imply home-seekers should be able to absorb this.

Looking Ahead

- **Growth** **Neutral**
  Macro indicators confirm a resilient U.S. economy, powered by the consumer and strong employment. Looking ahead to 2024, rising credit card lending, reduced excess savings particularly for lower income groups, waning fiscal support and refinancing of corporate debt at higher rates imply a shallow but short-lived slowdown in 2024. Our outlook for Europe remains weak i.e., sub-trend growth. China’s growth should be marginally lower than in 2023 as policymakers calibrate easing with prevention of systemic bubbles. Growth outlooks in India, Brazil, and Mexico remain robust.

- **Inflation** **Positive**
  Recent drop in inflation is a welcome development. Inflation should ease further in coming months, driven by base effects and cyclical factors. From a longer-term perspective however, greenification costs, peaking of China’s working age population, rejigging of global supply chains for greater geopolitical security, expansionary fiscal policies, and peak globalization point towards higher inflation in the next decade than in the one gone by.

- **Global financial conditions** **Positive**
  Lower interest rates and reduced risk premiums have eased financial conditions from their tights though the level remains tight relative to long-term history.

- **Valuations** **Negative**
  - Risk-free rates continue to present meaningful positive yielding anti-fragile alternatives.
  - Equity Valuations remain extremely expensive in the U.S. but are reasonable in most other parts of the world.
  - Corporate spreads are expensive, leaving almost no room for further compression. Risks are skewed to the side of widening if in case of an economic downturn.
  - Among Currencies, the U.S. Dollar is over-valued 10% based on our valuation models.

- **Technicals** **Negative**
  Speculative longs lengthened further in gold but eased further in oil. U.S. dollar net longs were reduced further. Net shorts in U.S. treasury futures remained stable at -2 standard deviations in duration adjusted terms. Shorts were added to S&P 500 contracts despite the rally. Retail investor sentiment remained in overbought territory with the AAII Bull-Bear spread at 21 from 29. Price momentum indicators for riskier assets moved into an overbought zone. Hedging through put options edged up but remained below its long-term median level. Overall, the market moved into an overbought zone, particularly if judged through the lens of price momentum indicators.

- **Risk orientation in asset allocation** **Neutral**
  Compressed risk premia force us to retain a defensive stance in our asset allocation despite the improved growth outlook and easing of financial conditions. At current levels, several asset classes (U.S. large cap equities and global corporate credit) are primed for perfection and likely to stutter if things do not go to plan. The source of frustration could come from a slowdown caused by simultaneous belt tightening by all three drivers (Government, consumers, and companies). Alternatively, resurgence of inflation could force central banks to start tightening again, which would hit risk assets. U.S. elections could cause volatility given ongoing legal proceedings against former President Trump.

Key risks

- 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.
- U.S. elections could spark volatility.
- Tax rates rise globally as governments try to flatten the income curve.

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