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Multi-Asset perspectives

Courtesy of Principal Asset Management

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Macro

- **Manufacturing indicators strengthened.** Our global Manufacturing PMI rose to 49.2 (+1), with US (49.1), China (49.2), EU (46.6) and EMs (50.6) all showing sequential improvement. Our Leading Regime Indicator just stayed on the expansionary side. Economic Surprises were flat in U.S., marginally negative in UK, Japan & China and positive in Euro area. Global employment trends remained strong, particularly in the U.S., continuing to drive consumption.
- **Global financial conditions** (FCIs) were almost unchanged as were its rate, spread, and volatility components. U.S. financial conditions remained tight relative to history.
- **Global inflation** was stable at 3.2%yoy in Dec '23 with DM inflation at 2.9% and EMs at 3.7%. 16/29 countries saw lower inflation. Recent progress on inflation remains encouraging though the trend must continue to assure policymakers that the inflation genie has been tamed. Market-based inflation measures (U.S. CPI implied by TIPs) went up 30bps in 2yrs, and 10bps each in 5 & 10 years but stayed within Fed's comfort zone of 2-2.5%.

Bottom-up

- **Global bottom-up earnings revisions were stable**. The 3m Earnings Revisions Ratio was almost unchanged at 0.43 (43% upgrades, 57% downgrades). We are likely to end 2023 with no EPS growth for MSCI AC World. Expected 2024 growth is 10% which could be challenged by a recession (though chances of one are receding). Comm services (15%), Health care (14%) and Cons discretionary (12%) are the sectors with the highest earnings growth expectations.
- **Year-end 2023 Global credit rating upgrades to total changes** was at 43% (43/57 upgrade/downgrade ratio). Global IG was at 58% and Global HY at 35%. Early days yet for 2024 but we will closely track changes as they happen.

Valuations

- **Global equity valuations remained expensive**. MSCI ACWI was cheaper than current levels 90% of the time in history, driven by expensive U.S. stocks (Large caps). US small caps, however, were cheap. Latin America and most parts of Asia remained cheap too with China standing out among large markets.
- **U.S. IG spread narrowed -3bps to 96bps** (35th %ile in history) **but HY spread was 21bps wider at 344bps** (26th %ile in history). Spreads remained expensive, baking in a blue-sky scenario of lower rates, lower inflation and continued economic expansion. 30-yr U.S. corporate spreads remained inside their long-term medians as demand for long-bonds remained strong.
- The **U.S. 10-yr treasury yield**, at 3.9% remained just below the lower end of our model implied fair value range of 4.1-4.9%.

Markets

- **Global Equities** had a mixed month, with half the indices closing in the red. The median local currency return was -0.2%. Large caps, Growth, IT, and financials outperformed. Japan (8%) performed the best among large markets. Chinese equities dropped noticeably (-6% Shanghai, -10% "H" shares listed in Hong Kong) as investors remained skeptical about recent Government efforts to revive sentiment. Over the past 12 months, while U.S. equities rose 21%, offshore Chinese equities tanked -29%, making them the worst performing large market. China's underperformance was the biggest drag on emerging equities over this period.
- **Fixed income**: There were six rate cuts (all in EMs – Brazil, Chile, Peru, Colombia, Hungary, Israel) and a hike (Turkey). Our global policy rate indicator was steady at 5.07% but will start dropping when developed economies start adjusting rates lower. The U.S. Federal Reserve acknowledged progress on inflation but is unlikely to start cutting rates till May or June, given strong employment numbers (Jan '24 non-farm payrolls jumped by 353k, the highest monthly gain since 482k in Jan '23 and the two-month change of 686k was the highest since Jun '22). Our Global Sovereign 10-yr yield indicator was up +5bps to 4% after dropping -73bps in Nov-Dec '23 with 25/28 countries experiencing higher yields. The global 2-10yr term spread steepened 9bps to -16bps with the U.S. at -29bps from -37bps. Credit spreads were wider for high yield, but lower for IG, particularly long-end bonds as demand stayed strong. *Returns were mixed, with long-end treasuries experiencing the largest drawdown. IG and HY yield eked out small positive returns*.
- **Currencies**: After its struggles in Nov-Dec of last year, the greenback made a comeback of sorts with widespread gains. Only one currency (Indian Ruppe) managed to defy the $ strength. The biggest losers were Chilean Peso (-6%), Japanese Yen, Aussie dollar, and Thai Baht (-4% each). Over the past 12 months too, the U.S. dollar remained the currency of choice, rising against 70% of the currencies we track it against. *The U.S. dollar remained overvalued based on our purchasing parity-based indices. The Japanese Yen is the most undervalued*.
- **Commodities**: The GS commodity index recovered 4% after losses in 4Q '23. Energy led with a gain of 5% as the rising conflict between U.S., Europe, and U.K on one side, and Iran-backed Houthi rebels in Yemen raised specter of supply shortages as ships in the Red Sea were bombed in retaliation for the ongoing Israeli offensive in Gaza. Fundamentally though, U.S. oil production in the range of 13-13.5mbpd continues to put down pressure on prices at a time when OPEC+ is struggling to enforce supply discipline.

US Housing Indicators

- U.S. home prices continued to edge up. The 20-city Case Schiller index increased 5.4%yoy, and the FHFA house price index 6.6%yoy in Nov '23. Home purchases remained supported by accumulated savings despite high mortgage rates. Those desirous of owning homes would welcome a reduction of at least 100-150bps. Lower mortgage rates could paradoxically cause prices to soften as they would encourage more supplies.
- On the other hand, the office sector remains challenged. Real Capital Analytics' (RCA) price indices showed prices dropping -16%yoy for overall offices, -29% for CBD (central business district) offices, and -13% for suburban offices.
- Lower mortgage rates since Nov '23 have helped affordability though levels remain weak relative to history. For context, if personal incomes rose 5%, home prices and mortgage rates dropped -5% and -100bps respectively, our affordability index would recover 30% to 77 (PAA Scenario in the chart below), which would still be 25% worse than its long-term average. Having said that, high equity in homes, significant deleveraging since the global financial crisis and manageable total mortgage costs (3.8% on outstanding stock) are strong mitigants.

Looking Ahead

- **Growth** **Neutral**
  Macro indicators confirm a resilient U.S. economy, powered by the consumer and strong employment. While we expect growth to moderate, the jury is still out if we will get a flat lining of growth or even a mild contraction for a quarter or two sometime this year. Our base case assumes such an outcome due to rising credit card lending, reduced excess savings for lower income groups, waning fiscal support and refinancing of corporate debt at higher rates though we acknowledge improving odds of a non-recessionary outcome. Our outlook for Europe remains weak i.e., sub-trend growth. China's growth should be marginally lower than in 2023. 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. Lower rates should ease them through the course of 2024.

- **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 little room for further compression. Risks are skewed to the side of widening in case of an economic downturn.
  - Among Currencies, the U.S. Dollar is over-valued 10% based on our valuation models.

- **Technicals** **Negative (but moving towards neutral)**
  Speculative longs came off marginally in gold but remained elevated due to rising geopolitical tensions. Oil net longs remained at low levels. U.S. dollar speculative positioning was neutral. 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. Retail investor sentiment remained positive but was off 4Q '23 highs with the AAII Bull-Bear spread at 13 from a high of 29. Price momentum indicators for riskier assets remained in overbought zone. Hedging through put options was stable but below its long-term median. Overall, while the market stayed in overbought zone, the momentum froth eased a bit.

- **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 financial conditions. Asset classes like U.S. large cap equities and global corporate credit are primed for perfection and could 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 and worrying geopolitical developments could cause volatility too.

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, the battle for the Red Sea, or the ongoing fight between Russia and Ukraine. The relationship between U.S. and China could add volatility during the U.S. election year.
- U.S. elections could spark volatility.
- 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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