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Multi-Asset perspectives

Courtesy of Principal Asset Management

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Macro

- **Macro Manufacturing indicators were mixed.** Our global Manufacturing PMI softened to 48.9 (-0.3) with US (-1.3, weaker new orders, employment & inventories but higher export orders), China (49.1 unchanged), EU (+0.5) and EMs (+0.3). We think of it as a temporary setback to the recent recovery in the global manufacturing outlook. Our Leading Regime Indicator was unchanged and stayed in the mildly expansionary territory. Economic Surprises were negative in the U.S. but turned positive in all other regions, pushing our global economic surprise indicator back into positive territory.
- **Global financial conditions** (FCIs) were unchanged again. A slight tightening of conditions through higher rates was offset by loosening through reduced volatility and equity momentum. U.S. financial conditions remained tight relative to history.
- **Global inflation** eased to 2.9% yoy in Jan'24 with DM inflation at 2.7% and EM at 3.2% (there was a noticeable drop in inflation in Eastern European countries). 20/29 countries saw lower inflation. While global inflation has softened considerably since mid-2023, the recent rise in global oil prices and shipping costs due to the Middle East conflict poses a danger that the last mile towards Central bank inflation targets could be challenging. Indeed, recent moves in bond yields (higher) and market-based inflation measures (U.S. CPI implied by TIPs) reflect this, with 2-yr TIPS higher by 75bps to 2.79%, and 10-yr TIPS by 15bps to 2.32% in the last two months.

Bottom-up

- **Global bottom-up earnings revisions** were stable. The **3m Earnings Revisions Ratio** was almost unchanged, with 42% upgrades and 58% downgrades.
- **Year-end 2023 Global credit rating upgrades to total changes** was at 43%. Global IG was at 58% and Global HY at 35%. The ratings momentum should improve if expected earnings growth materializes.

Valuations

- **Global equity valuations remained expensive**. MSCI ACWI was cheaper than current levels 92% of the time in history, driven by expensive U.S. stocks (Large and midcaps). US small caps, however, were fair value. Latin America and most parts of Asia remained cheap. China, despite the rally in February, remained on the cheap side.
- **U.S. IG spread was unchanged at 96bps (35th %ile in history) but HY spread narrowed-32bps to 312bps (14th %ile in history**. Spreads are baking in a blue-sky scenario of continued expansion and easy financial conditions. 30-yr U.S. corporate spreads were at 32nd %ile (A rated) and 24th %ile (BBB rated) as demand for long-bonds remained strong.
- The **U.S. 10-yr treasury yield**, at 4.25% was at the lower end of our model implied fair value range of 4.2-5%.

Markets

- **Global Equities** had a strong month, with 80% of the indices closing in the green with a median local currency return of 3.4%. Large caps, Momentum, Growth, IT (all were significantly influenced by the AI theme, with NVIDIA results sending related stocks into a new orbit), and consumer discretionary stocks outperformed. Chinese onshore stocks (8-11%) finally recovered. Domestic institutions including domestic sovereign wealth funds turned aggressive buyers as the policymakers set in motion more supportive measures including new trading restrictions. Technicals (deeply oversold) and valuations (very cheap) played their part too. Since Nov' 23, S&P 500 is up 22%, Nasdaq 25%, MSCI Europe 17% and MSCI EMs 12% (Chinese equities were still negative) in a sharp turnaround in global sentiment. While the initial rally was propelled by declining inflation and hopes of aggressive rate cuts, the baton has since been passed to growth and corporate earnings even as some concerns lurk on the trajectory of both inflation and monetary policy.
- **Fixed income**: There were three rate cuts (all in EMs - Peru, Hungary, and Czech Republic). Our global policy rate indicator eased-1bp to 5.06% but will start dropping when developed economies start adjusting rates lower. The U.S. Federal Reserve acknowledged progress on inflation, but market expectations of rate cuts are dropping, given strong growth and an uptick in inflation in the last few weeks. Versus six at the start of the year, only three cuts are being priced now. Our Global Sovereign 10-yr yield indicator was up +15bps to 4.25% with 23/28 countries experiencing higher yields. The global 2-10yr term spread narrowed-10bps to-25bps with the U.S. at-37bps from -29bps. Credit spreads narrowed sharply for high yield, but were unchanged for IG. Strong demand for corporate bonds was matched by strong issuance. *Returns were mixed, with long-end treasuries experiencing the largest drawdown, followed by core IG. HY generated positive returns, driven by tighter spreads.*
- **Currencies**: The U.S. Dollar appreciated slightly with the tailwind of higher yields. The moves were not large, which probably explains the co-existence of dollar strength and significant risk-on sentiment in equities and credit. Its largest gain was against Chilean Peso (4%) and its largest drop against the Mexican Peso (-1%). *The U.S. dollar remained overvalued based on our purchasing parity-based indices. The Japanese Yen remained the most undervalued*.
- **Commodities**: The GS commodity index edged up 1%, with sustained gains in energy (2%) offsetting mild losses in other sectors. The rising conflict between U.S., Europe, and U.K on one side, and Iran-backed Houthi rebels in Yemen continues to present upside risks to oil prices, reflecting higher geopolitical risk premium, and higher insurance and shipping costs in using alternate routes to the Red Sea. On the other hand, U.S. oil production in the range of 13-13.5mbpd continues to put down pressure on prices at a time when OPEC+ has not been able to force supply discipline on its partners.

US Housing Indicators

- U.S. home prices continued to edge up. The 20-city Case Schiller index increased 6.1%yoy, and the FHFA house price index 6.6%yoy in Dec '23. Home purchases remained supported by accumulated savings despite high mortgage rates amidst low supplies. Lower mortgage rates could paradoxically cause prices to soften by increasing supplies.
- On the other hand, the office sector remains challenged. Real Capital Analytics' (RCA) price indices showed prices dropping-15%yoy for overall offices, -29% for CBD (central business district) offices, and-12% for suburban offices.
- U.S. housing affordability has been hovering around 60% of its 15-year average. If personal incomes rose 5%, home prices and mortgage rates dropped-5% and-100bps respectively, affordability would recover by about 30% from current, but will still be 20% 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** **Positive (from Neutral)**
  Macro indicators confirm a resilient U.S. economy. Almost all cylinders are firing as evidenced by 4Q' 23 GDP which showed personal consumption rise 2.7% yoy, private investment 1.5% yoy, and Govt. consumption 4.5% yoy. The risks to the U.S. outlook are an uptick in credit card delinquencies which shows reduced excess savings with lower income groups, and refinancing cliff for floating rate borrowers. Admittedly, growth outlooks in Europe remain challenged but China's attempts to revive its capital markets could have a modest positive impact on both consumer and corporate spending. Growth outlooks in India, Brazil, and Mexico remain robust.

- **Inflation** **Positive but risks are rising**
  Recent inflation readings indicate a roadblock or two in the path towards Central bank inflation targets in U.S., and Europe. Higher commodity prices and rising freight costs arising from the Middle East conflict could add to the challenge but we remain hopeful that inflation will be lower in a few months. 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**
  Tight spreads and continued equity market momentum have prevented financial conditions from tightening despite higher rates since the start of 2024. We remain hopeful that rate cuts in U.S. and Europe will ease conditions as we step into the second half.

- **Valuations** **Negative**
  - Risk-free rates continue to present meaningful positive yielding anti-fragile alternatives.
  - Equity Valuations remain expensive in the U.S. but are reasonable in several 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 about 10% based on our valuation models.

- **Technicals** **Negative**
  U.S. dollar speculative longs edged up but were not extended. U.S. treasury positioning remained net short in duration adjusted terms relative to history. Oil positioning turned higher but wasn't extended. Shorts were added to S&P 500 and Nikkei contracts. Retail investor sentiment remained very positive with the AAII Bull-Bear spread jumping to 25 from 13. Price momentum indicators for equities remained in overbought zone. Hedging through put options was stable but below its long-term median. Risk-parity and volatility based quantitative strategies were noticeably biased towards equities. Overall, the market appeared to be in an overbought zone by the end of Feb' 24.

- **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 our expectation of 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 woes in the property sector or belt tightening by U.S. consumers, who have been using up past savings to support spending.

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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