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Multi-Asset perspectives

Courtesy of Principal Asset Management

March 2024

Macro

- **Manufacturing indicators strengthened.** Our global Manufacturing PMI rose above 50 for the first time since Sep'22. It gained +1.5 points to 50.4 with gains in the U.S. (50.3 from 47.8), China (50.8 from 49.1), EU (47.5 from 47.1) and EMs (52.3 from 50.9). February's setback indeed turned out to be temporary. Our Leading Regime Indicator was a tad softer though due to weakness in new orders in Japan and Germany. Economic Surprises were flat in the U.S. and Japan but positive in Europe and China, keeping our global economic surprise indicator in positive territory.
- **Global financial conditions** (FCIs) were easier, driven by tighter spreads, better equity momentum, and stronger monetary growth. The interest rate component was almost unchanged. U.S. financial conditions remained tight relative to history.
- **Global inflation** edged up to 3.2%yoy in Feb'24 from 2.9%yoy the month prior, with fourteen countries recording higher inflation due to higher energy prices. The biggest change was in China where CPI rose from -0.8% to 0.7% which pulled EM inflation to 4.1% from 3.2% even as DM inflation was stable at 2.7%. Recent increases in energy and shipping costs (geopolitical risks, manufacturing recovery) pose a risk 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 break-even inflation higher by 68bps, and 10-yr by 15bps since the start of the year.

Bottom-up

- **Global bottom-up earnings revisions** were stable. The **3m Earnings Revisions Ratio** was almost unchanged, with 43% upgrades and 57% downgrades. Expected earnings growth for 2024 for MSCI AC World was stable at 10% though corporate earnings were strong for the recently concluded quarter relative to expectations.
- **Year-end 2023 Global credit rating upgrades to total changes** was at 50% relative to 44% at the end of the last year. Global IG was at 65% and Global HY at 40%. The ratings momentum should improve further if the 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 tightened to 90bps (25th %ile in history) and HY spread to 299bps (10th %ile).** Spreads continue to bake a blue-sky scenario of continued expansion and easy financial conditions. 30-yr U.S. corporate spreads were at 24th %ile (A rated) and 16th %ile (BBB rated) as demand for long-bonds remained strong.
- The **U.S. 10-yr treasury** yield, at 4.2% was at the lower end of our model implied fair value range of 4.1-5%.

Markets during the month

- **Global Equities** had another strong month. Eighty percent of the indices closed in the green with a median local currency return of 2.6% that took YTD median return to 5.5%. Spain and Taiwan were the best performing countries. Though small caps, value, and energy outperformed (improved market breadth), momentum, IT, and consumer discretionary won the quarter handsomely. Chinese onshore and offshore stocks delivered marginally positive returns after a strong showing in February. It seems like improved growth prospects on the back of policy support is impacting market sentiment positively. The 4Q'23 earnings season was strong, with strong beats in U.S., Europe, and Japan. Asia saw earnings misses, driven primarily by China.

- **Fixed income:** Bank of Japan finally ended its negative interest rate policy. The Swiss National Bank became the first DM central bank to cut rates in this cycle. However, a 500bp rate hike by Turkey nudged our global policy rate indicator 3bps higher to 5.09%. it will start dropping later this year as U.S. and Europe start their rate cut cycles. The U.S. Federal Reserve acknowledged progress on inflation and maintained its forecast of three rate cuts this year. Our Global Sovereign 10-yr yield indicator was almost unchanged at 4.24% though 17/29 countries had lower yields. The global 2-10yr term spread was also unchanged at -26bps though the U.S. inverted further to -42bps from -37bps. Credit spreads narrowed, both for high yield and investment grade as demand for spread products remained strong. *Returns were positive, propelled primarily by tighter spreads.*

- **Currencies:** The U.S. Dollar appreciated slightly. The moves were not large, which explains another month of co-existence of dollar strength and the broader risk-on sentiment. Its largest gain was against the Turkish Lira (4%) and its largest drop against the Mexican Peso (-3%). *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 rose 4%, with gains across the board. Precious metals (9%) had their best month in the last twelve months with strong demand from central banks looking to diversify their forex reserves. Energy prices gained another 4% due to the ongoing geopolitical conflict in the Middle East and renewed OPEC supply discipline. On the other hand, U.S. oil production remained near its all-time high of 13-13.5mbpd.

U.S. Housing Indicators

- 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, significant deleveraging since GFC and stronger personal balance sheets are meaningful offsets to worsened affordability.
- U.S. home prices were flat in Jan'24 vs Dec'23 but YoY gains were strong at 6.6% and 6.3% respectively. Home purchases remained supported by accumulated savings despite high mortgage rates. Lower mortgage rates could paradoxically cause prices to soften by increasing supplies.
- The commercial property sector remains challenged. Real Capital Analytics' (RCA) price indices that prices continue to ease for office and residential properties though the rate of change is improving. As of Feb'24, overall commercial property prices dropped -2%yoy with residential dropping -9% and office -15% (CBD -30%, suburban -12%). Industrial prices, however, appreciated 2%.

Looking Ahead

1. Growth **Positive**

Macro indicators confirm a resilient global economy, led by the U.S. All cylinders are firing as evidenced by strong global employment, personal consumption, and govt. spending. Corporate earnings outlook has improved in recent months riding a recovery in manufacturing output. Admittedly, growth outlook in Europe remains challenged but China's attempts to revive its economy seems to be having a modest positive impact on both consumer and companies. Growth outlooks in India, Brazil, and Mexico remain robust.

2. Inflation **Positive but with rising near-term risks**

Higher commodity prices and rising freight costs arising from the Middle East conflict are re-creating inflationary pressures in certain pockets, but we remain hopeful that global inflation will be lower in the months to come. 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. Central banks are likely to accept it as something that monetary policy cannot fix without putting growth at risk and give themselves a longer period to achieve targets.

3. Global financial conditions **Positive**

Tighter spreads and equity market momentum have prevented financial conditions from tightening despite higher bond yields since the start of 2024. We remain of the view that rate cuts in U.S. and Europe will ease conditions as we step into the second half of the year. However, the magnitude of easing would be small if growth remains strong.

4. Valuations **Negative**

- **Risk-free rates** continue to present meaningful positive yielding anti-fragile alternatives.
- **Equity Valuations** remain expensive in the U.S. but are more reasonable in other parts of the world.
- **Corporate spreads** are tight, leaving little room for further compression.
- Among **Currencies,** the U.S. Dollar is over-valued about 10% based on our valuation models.

5. Technicals **Negative**

Price Momentum was high for risk assets, based on both moving averages and relative strength. Retail investor sentiment remained positive with the AAII Bull-Bear spread at 28 (0=neutral). Hedging through put options was stable but below its long-term median. Risk-parity and volatility based quantitative strategies were heavy on equities. Overall, the equity market was in an overbought zone.

6. Asset allocation orientation Neutral

Compressed risk premia have forced us to retain a defensive stance in our asset allocation despite the improved growth outlook and our expectations of easing financial conditions. Asset classes like U.S. large cap equities and global corporate credit are pricing goldilocks and could stutter if things do not go to plan. The source of frustration could come from the following risks -

- Uptick in credit card delinquencies due to reduced excess savings with lower income households.
- Floating rate borrowers face a refinancing cliff as old loans mature and are repriced significantly higher.
- 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.
- Tax rates rise globally as governments try to flatten the income curve.

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