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Multi-Asset perspectives

Courtesy of Principal Asset Management

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Macro

- **Manufacturing indicators were mixed**. Our global Manufacturing PMI slipped back below 50 after crossing it for the first time in Mar'24 since Sep'22. It slipped -0.5 points to 49.8 with weakness in U.S. (49.2 from 50.3), China (50.4 from 50.8), EU (47 from 47.5) and EMs (51.8 from 52.3). However, our Leading Regime Indicator went the other way, helped by stronger new orders. Economic Surprises were positive in Europe but negative in other regions.
- **Global financial conditions** (FCIs) were tighter, driven by higher rates, wider spreads, weaker equity momentum, and weaker monetary growth. The stronger the growth outlook, the more the chance that financial conditions remain on the tighter side for a longer period. U.S. financial conditions remained tight relative to history.
- **Global inflation** edged down to 3.1%yoy in Mar'24 from 3.3% the month prior, with nine countries recording higher inflation and seventeen lower. Inflation in developed economies was stable at 2.7%, while that in emerging economies eased to 3.7% from 4.1%. Recent increases in energy and input prices in manufacturing PMIs pose a risk that it would take longer for inflation to reach Central bank policy targets. Indeed, recent moves in bond yields (higher) and market-based inflation measures (U.S. CPI implied by TIPs) reflect this, with 10-yr break-even inflation higher by 23bps since the start of the year to 2.40%.

Bottom-up

- **Global bottom-up earnings revisions** were stable. The 3m Earnings Revisions Ratio improved, with upgrades edging up to 45% from 43%. Expected earnings growth for 2024 for MSCI AC World ticked down to 9%, primarily due to a strong US$.
- **Global credit rating upgrades to total changes** was at 49% relative to 43% on 12/31/2023. Global IG was at 67% vs 57% and Global HY at 38% vs 35%. Ratings momentum should improve further if the expected earnings growth materializes.

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 and midcaps). US small caps, however, were fair value. Latin America and most parts of Asia remained cheap. China, despite the recent rally, remained on the cheaper side.
- U**.S. IG spread tightened to 87bps (21st %ile in history) while HY spread was stable at 301bps (12th %ile).** Spreads continue to bake a blue-sky scenario of continued expansion and easy financial conditions. 30-yr U.S. corporate bond spreads were at 21st %ile (A rated) and 15th %ile (BBB rated) as demand for long-bonds remained strong. Structured product demand remained strong, pushing spreads tighter for CLOs and CMBSs.
- **The U.S. 10-yr treasury** yield, at 4.7%, moved to the middle of our model implied fair value range of 4.3-5.2%.

Markets during the month

- **Global Equities** corrected. Half the indices closed in the red. The median local currency return was -0.4% that eased YTD median return to 4.9%. Among major markets, offshore China shares jumped 8%, continuing a good run that started in Feb'24. Improved growth prospects on the back of policy support are having a more lasting impact on market sentiment. U.S. equities were the weakest, dropping between -4% to -7% as markets repriced the policy rate path higher. Value outperformed, followed by Low volatility stocks as momentum lagged. Large caps outperformed small caps in U.S., Japan, and China. Energy and Materials had strong relative numbers versus broader markets. IT lagged.
- **Fixed income**: Our global policy rate indicator was stable at 5.09% though Hungary, Chile, Peru, and Colombia nudged rates lower. Indonesia went the other way. Developed market central banks were missing in action. With the Federal Reserve not ready to cut rates yet, the ECB could start its rate cut cycle ahead of it. Every country saw higher yields, which pushed our Global Sovereign 10-yr yield indicator 32bps higher to 4.56%. The global 2-10yr term spread was less inverted at -17bps from -26bp, with the U.S. at -36bps from -42bps. Credit spreads narrowed a tad for investment grade but were almost unchanged for high yield. Demand for spread products remained exceptionally strong. Returns were negative, reflecting higher yields. Longer duration products suffered more than short duration ones.

- **Currencies**: The U.S. Dollar appreciated against 90% of the currencies we track it against. It gained ~4% each against the Japanese Yen (the BoJ remained ultra dovish despite moving off negative rates), Brazilian Real and Mexican Peso. On the other hand, the Chilean Peso recovered 2% against the greenback, which cut its YTD decline to -9%. The U.S. dollar remained overvalued based on our purchasing parity-based indices. The Japanese Yen was the most undervalued.
- **Commodities**: The GS commodity index was almost unchanged for the month but showed divergence within. Industrial metals (recovering Chinese demand, U.S. ban on import of Russian metals like aluminum) jumped 12%. Precious metals were up 4% on central bank buying and continued Middle East tensions. Energy took a breather after jumping 12% in the prior three months. A peace deal between Israel and Hamas has the potential to bring energy prices down further.

U.S. Housing Indicators

- **U.S. housing affordability** has been hovering around 60% of its 15-year average. For affordability to even reach 75%, personal incomes would have to rise 5%, home prices drop -10%, and mortgage rates drop -100bps. Deleveraging since GFC (U.S. Household debt/GDP is 46% vs pre-GFC level of 70%) makes us believe that homebuyer activity will start accelerating should affordability recover to that level.
- **U.S. home prices** were up in Mar'24 despite high mortgage rates, rising ~7%yoy based on both the Case-schiller index and the FHFA house price index. While home listings are rising, they remain low relative to history, giving sellers the upper hand in price negotiations.
- **The commercial property sector** remains challenged. Real Capital Analytics' (RCA) indices showed that prices dropped again for all sub-sectors barring industrials. However, the rate of change improved. As of Mar'24, overall commercial property prices dropped -1%yoy with residential dropping -8% and office -17% (CBD -33%, suburban -11%). Industrial prices appreciated 6%.

Looking Ahead

1. **Growth** — **Positive**

   Though U.S. ISM Manufacturing and Service Indices edged lower and employment growth slowed in April, it is early to say that the global economy is running out of steam. Atlanta Fed's GDP Now indicator for U.S. is above 3% versus a structural growth rate around 2%. While European outlook remains challenged, activity is stabilizing. China's attempts to revive its economy seem to be bearing fruit with 1Q'24 GDP slightly above goal at 5.3%yoy. Recovering stock markets should boost both consumer and corporate confidence in the second largest economy of the world. Growth outlooks in other emerging markets like India, Brazil, and Mexico remain robust.

2. **Inflation** — **Neutral from Positive**

   Inflation angst persists with the U.S. Federal Reserve acknowledging a stalling of the progress towards their goal. Higher commodity prices due to the Middle East conflict have re-created risks of supply-push inflation at a time when consumer demand remains strong. While our view is that inflation softens in coming months, risks have clearly risen which causes us to downgrade this factor to neutral. From a longer- term perspective, 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 the one gone by.

3. **Global financial conditions** — **Neutral from Positive**

   While we expect rate cuts to come eventually, risks are that U.S. yields remain higher for longer, which causes us to downgrade this factor to neutral from positive. However, tight equity and credit risk premiums due to robust growth and earnings recovery should prevent financial conditions from tightening meaningfully.

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 reasonable in other parts of the world.
   - **Corporate spreads** are tight, leaving little room for further compression.
   - **Among currencies**, the U.S. Dollar remains over-valued about 10% based on our valuation models.

5. **Technicals** — **Neutral from Negative**

   Price Momentum weakened for equities. Retail investor sentiment also turned neutral from exalted levels, with the AAII Bull-Bear spread at -2 from 28 (neutral = 0). Hedging through put options, however, remained below its long-term median. Risk-parity and volatility based quantitative strategies reduced equity allocations. Overall, equity market technical positioning moved towards neutral from overbought.

6. **Asset allocation orientation** **Neutral**

Compressed risk premia keep our stance defensive stance despite better growth prospects. 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 commercial real estate sector sees a hard landing, led by the challenged office sector.
- Geopolitical risks worsen (the Israel-Hamas conflict, Russia-Ukraine war).
- The relationship between U.S. and China adds volatility as U.S. elections approach.
- Tax rates rise globally as governments try to flatten the income curve and fund their expanding deficits.

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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