Multi-Asset perspectives

Courtesy of Principal Asset Management

May 2024

Macro

- **Manufacturing indicators were broadly stable.** Our global Manufacturing PMI was at 49.7 vs 49.8 with weakness in U.S. (48.7 from 49.2) and China (49.5 from 50.4) compensated for by Europe (48.4 from 47). Our leading regime Indicator was also stable though new orders exhibited loss of momentum relative to a strong April. Economic Surprises were positive in Europe and Japan but negative in China and U.S.
- **Global financial conditions** (FCIs) were a tad easier, driven by lower rates, slightly tighter spreads, better equity momentum, and less drag from monetary growth. U.S. accounted for bulk of this easing.
- **Global inflation** was stable at 3.1%yoy in Apr'24, with ten countries recording higher inflation and thirteen lower. Inflation in developed economies was one-tenth lower at 2.6%, while that in emerging economies was up two-tenths to 3.9%. There is little doubt that continued strength in services inflation has the markets and the U.S. federal reserve concerned since the start of the year. However, a month or two of softer readings could bring rate cuts back on the table. U.S. policymakers would be encouraged by the decline in 2-yr break-even inflation rate by -17bps in May, though still up 25bps for the year.

Bottom-up

- **Global bottom-up earnings revisions** improved at the margin. 3-month Earnings Revisions Ratio improved further, with upgrades edging up to 47% from 45%. Expected earnings growth for 2024 for MSCI AC World ticked up to 10%.
- **Global credit rating upgrades to total changes** edged up to 50% relative to 43% on 12/31/2023. Global IG rose to 70% vs. 67% while Global HY was stable at 38%. Ratings momentum should improve further if the expected earnings growth materializes.

Valuations

- **The U.S. 10-yr treasury yield,** at 4.5%, remained inside our model implied fair value range of 4.4-5.2%.
- **U.S. IG spread tightened to 85bps (19th %ile in history) while HY spread was a tad wider at 308bps (13th %ile).** Spreads continue to bake a blue-sky scenario of continued expansion and tremendous demand for spread products which has allowed borrowers to stretch out their maturities. 30-yr U.S. corporate bond spreads were at 27th %ile (A rated) and 17th %ile (Baa rated) as demand for long-bonds remained strong. Structured product demand remained strong too, tightening spreads for both CLOs and CMBSs.
- **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 caps). 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.

Markets during the month

- **Global Equities** recovered from their April correction. Eighty-eight percent of the indices gained. The median local currency return was 2% that pushed up YTD'24 median return to 8%. Among major markets, offshore China shares, U.S. small caps and Nasdaq clocked return of 4-5%. Lower yields helped as inflation readings were not as concerning as in the month prior. Momentum outperformed globally though Growth was a clear winner in the U.S. The gap between large and small caps was marginal barring Europe where the latter outperformed. IT and Utilities stole the show among sectors.
- **Fixed income: O**ur global policy rate indicator was at 5.08%. Rate cuts took place in Sweden, Brazil, Chile, Peru, Hungary, and Czech Republic. Among major developed market central banks, ECB seems closest to a cut. 25/29 countries experienced lower yields, easing our Global Sovereign 10-yr yield indicator -11bps to 4.45%. The global 2-10yr term spread got more inverted at -23bps from -17bps, with the U.S. at -39bps. Credit spreads narrowed a tad for investment grade (U.S. IG at 85bps) but widened slightly for high yield (U.S. HY at 308bps). Both remained in the tightest 20th percentile in history. Demand for spread products remained exceptionally strong. Returns were positive, reflecting lower yields. Longer duration products gained more than shorter duration ones.

- **Currencies:** The broad trade weighted U.S. Dollar eased -1% as the greenback lagged 77% of the currencies, we track it against. Its largest drop was against the Norwegian Krone (-6%). Year till date, however, the greenback has made gains against every currency barring two (GBP and Colombian Peso), against whom it has dropped about two-tenth of a percent each.
- **Commodities:** The GS commodity index eased -2%. Precious metals (3%) continued to shine (16% in 3 months). Industrial metals were strong too (recovering Chinese demand, U.S. ban on import of Russian metals like aluminum), clocking gains of 18% over 3 months. Energy declined -5% on continued profit taking.

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 would need to drop -10%, and mortgage rates -100bps for affordability to reach 75%. However, deleveraging since the global financial crisis (U.S. Household debt/GDP is 46% vs 70% pre-GFC), lower home ownership rate, and low mortgage rates on existing mortgages (3.8%) imply limited downside risks. While Fannie Mae's home purchase sentiment index has improved in recent months, persistently high mortgage rates are likely to start capping home price gains (prices were up ~7%yoy in Mar'24).
- The commercial property sector remains challenged. However, the decline could be ebbing. Real Capital Analytics' (RCA) indices showed that overall commercial prices were stable in April. The yoy drop has narrowed from a peak of -7% to -1% in recent months. Residential prices recorded a decline of -7% (peak -14%), while office prices dropped -15% (peak -17%). Industrials gained +6%, defying the trend in other sectors.

Looking Ahead

1. Growth **Positive**

Though U.S. ISM Manufacturing and Service Indices have edged lower lately, employment growth slowed in April (the May numbers will be out next week) and the Atlanta Fed's GDP Now indicator for U.S. has dropped from 3% to just under 2% in recent weeks, it is early to say that a meaningful slowdown below trend growth (~2%) is upon us. European outlook has improved lately. China seems to have embarked on a mission to revise growth and employment and is trying to find a fix for its housing problem. Recovering stock markets should boost both consumer and corporate confidence. Growth outlooks in other emerging markets like India and Brazil remain robust.

2. Inflation **Neutral**

These are early days but softer releases in the last month have raised hope that we may be past the worst of the inflation spike that sent bond yields sharply higher since the start of the year. While energy prices have rolled over in the last few weeks, container freight rates have moved higher, reinforcing that geopolitical risks remain significant. Our view remains that inflation will soften in coming months, but risks cannot be ignored. 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**

While we expect rate cuts to come eventually, risks are that U.S. yields remain higher for longer, which causes us to keep this factor at neutral at a time when compressed risk premiums are unlikely to contribute much towards further easing of financial conditions.

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.

5. Technicals **Neutral**

Price Momentum recovered for equities. Hedging through put options remained near its long-term median. Retail investor sentiment improved but was not in an overbought zone, with the AAII Bull-Bear spread at 12 from -2 (neutral = 0). The National Association of Active Investment Manager survey showed an increase in equity positioning from 59 to 92, though it stayed in neutral territory (range -200 to +200).

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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