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Multi-Asset perspectives

Courtesy of Principal Asset Management

June 2024

Macro

- **Manufacturing indicators were broadly stable.** Our global Manufacturing PMI was at 49.3 from 49.7 stable U.S. (48.5 from 48.7) and China (49.5, unchanged) but weaker Europe (47.3 from 48.4). Our leading regime Indicator ticked up marginally on recovering raw material prices and an uptick in new orders. Economic Surprises were positive in Europe and Japan but negative in China and U.S.
- **Global financial conditions** (FCIs) were marginally tighter, driven by wider spreads weaker equity momentum. Rates (marginally lower) and monetary growth (smaller dragged) limited the tightening.
- **Global inflation** was slightly higher at 3.3%yoy in May'24, with sixteen countries recording higher inflation and ten lower. Inflation in developed economies was stable at 2.5%, while that in emerging economies was up three-tenths to 4.5%. While inflation has surprised on the upside this year, a month or two of softer readings will affirm that inflation is headed in the right direction. U.S. policymakers would be encouraged by the decline in 2-yr break-even inflation rate from a peak of 2.77% in February to 2.27% by the end of June.

Bottom-up

- **Global bottom-up earnings revisions** had a positive tilt. 3-month Earnings Revisions Ratio improved, with upgrades edging up to 49% from 47% (41% at the start of the year). Expected earnings growth for 2024 for MSCI AC World was steady at 10%.
- **Global credit rating upgrades to total changes** was stable at 50% relative to 43% on 12/31/2023. Global IG was at 70% vs. 58% while Global HY was at 40% vs. 38%. Ratings momentum could improve further if the expected earnings growth materializes.

Valuations

- The **U.S. 10-yr treasury yield**, at 4.4%, remained inside our model implied fair value range of 4.4-5.2%.
- **U.S. IG spread widened a tad to 90bps (31st %ile in history)** while **HY spread was stable at 309bps (13th %ile)**. Spreads continue to bake a blue-sky scenario (solid economic growth and strong demand for spread products) which has allowed borrowers to stretch out their maturities. 30-yr U.S. corporate bond spreads were at 25th %ile (A rated) and 16th %ile (Baa rated) as demand for long-bonds remained strong. Structured product demand remained strong too.
- **Global equity valuations remained expensive**. MSCI ACWI was cheaper than current levels 94% 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.

Markets during the month

- **Global Equities** were positive though the breadth was weak. Taiwan (9%), India (7%) and U.S. (Nasdaq 6%, S&P 500 4%) helped MSCI All Country World to a 2% gain (YTD 11.3%), but the median local currency return was -1% (YTD median return 6%), with 63% of the markets in the red. Europe had a tough month. The announcement of snap parliamentary elections in France spooked markets given rising likelihood of dominance of the far-right. Growth, Quality and Momentum were the winning styles which also implied outperformance of IT and consumer discretionary stocks relative to energy, financials, and industrials. Large caps had a strong month relative to small caps.
- **Fixed income**:
    - **Policy Rates**: Eight cuts (four in developed economies i.e., Eurozone, Canada, Switzerland, and Denmark, and four in emerging economies i.e., Chile, Colombia, Hungary, and Czechia) pushed down our policy rate indicator to 5.13% from 5.19%. We expect the U.S. Federal Reserve to cut once in 3Q'24. A second cut in 4Q'24 is possible if inflation keeps sliding lower as in recent weeks.
    - **Bond Yields**: Our Global Sovereign 10-yr yield indicator was almost unchanged at 4.53%, which steepened the global 2-10yr term spread to -20bps (U.S. at -36bps) from -26bps.

- **Credit Spreads**: Credit spreads widened for U.S. investment grade (94bps from 85bps) but was unchanged for U.S. high (309bps). Demand for spread products remained strong.
- **Returns**: Returns were low and positive, with high yield (carry) and long-end treasuries (lower yields) outperforming.

- **Currencies**: The broad trade weighted U.S. Dollar gained 2% as the greenback beat 70% of the currencies. It gained the most against Mexican Peso (8%) as election outcomes raised the probability of market-unfriendly constitutional changes. Year till date, the greenback has made gains against every currency barring three (GBP, Ruble, and Colombian Peso).
- **Commodities**: The GS commodity index edged up by 1%. Breadth was weak with energy the only sub-sector to record gains (5%). Precious metals were stable (China dampened rising enthusiasm for gold by announcing it was no longer buying gold for reserves) while base metals and agricultural commodities dropped.

U.S. Housing Indicators

- U.S. housing affordability has been hovering around 60% of its 15-year average due to a combination of higher mortgage rates and rising home prices. For instance, the monthly EMI on a 30-year mortgage to finance a median home has jumped 120% between 2021 and 2024. A reversion to mean would require higher incomes, a sharp drop in mortgage rates, and a correction in home prices. However, deleveraging since the global financial crisis (U.S. mortgage debt/GDP is 46% vs 70% pre-GFC), lower home ownership rate (66% vs 69% pre-GFC), and low mortgage rates on existing mortgages (3.8% vs new 30-yr mortgages at 7.3%) imply limited downside risks.
- The commercial property sector remains challenged. However, the decline could be ebbing. Real Capital Analytics' (RCA) indices showed that overall commercial prices were down -2%yoy in May, which has narrowed from -11% about a year back. Apartment prices recorded a decline of -9% (peak -14%), while office prices dropped -17% (peak -18%). Industrials gained +9%, defying the stress in office prices.

Looking Ahead

1. **Growth** **Positive**

   Though U.S. ISM Manufacturing and Service Indices have been volatile lately, employment growth remains solid, both in the U.S. (May saw an addition of 272k jobs versus 165k the month prior) and most parts of the world. While U.S. GDP growth has slowed towards a trend growth of 2%, both China and Europe are showing recovery. Growth outlooks in other emerging markets like India 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. We remain of the view that inflation will soften in coming months, but risks still exist that inflation stays above policymaker targets for some more time. 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** **Negative from Neutral**

   Price Momentum has recovered, particularly in technology, growth, and quality stocks. Retail investor sentiment is headed into the overbought zone (the AAII Bull-Bear spread rose to sixteen from twelve with zero signifying neutral). Hedge funds are running extended net longs in momentum ideas, which raises the chances of a correction. However, market hedging through put options remained near its long-term median.

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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