

# Multi-Asset perspectives

Courtesy of Principal Asset Management

July 2024

## Macro

- **Manufacturing indicators were weaker.** Our global Manufacturing PMI index contracted for a fourth straight month to 48.6 with U.S. (46.8 from 48.5) contracting the most. China (49.4) and Euro Area (47.2) were stable. Our leading regime Indicator was stable at 50.1, implying borderline growth. Economic Surprises were negative in all major regions globally.
- **Global financial conditions** (FCIs) were easier, helped by lower rates and tighter credit spreads. Equity momentum and monetary growth were stable. Lower rates are likely to ease financial conditions further in coming months.
- **Global inflation** was slightly lower at 3.2%yoy in Jun'24, with seventeen countries recording lower inflation and nine lower. Inflation in developed economies was at 2.4%, and 4.3% in emerging economies (both lower than the month prior). Global inflation surprise was negative for a second month running. U.S. policymakers would be encouraged by the recent decline in implied break-even inflation rates from TIPS, with 2-yr finishing at 1.78%, 5-yr at 2.14% and 10-yr at 2.23%.

## 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** ticked up to 52% relative to 43% on 12/31/2023. Global IG was at 70% vs. 58% while Global HY was at 40% vs. 35%. Ratings momentum could improve further if the expected earnings growth materializes.

## Valuations

- The **U.S. 10-yr treasury** yield, at 4% moved below our model implied fair value range of 4.2-5.1%.
- **U.S. IG spread was stable at 93bps (29<sup>th</sup> %ile in history) while HY spread widened a little to 314bps (15<sup>th</sup> %ile).** 30-yr U.S. corporate bond spreads moved to 48<sup>th</sup> %ile (A rated) and 30<sup>th</sup> %ile (Baa rated) as long corporate bond yields could not keep pace with rapidly declining sovereign yields. Both corporate and structured product demand remained strong. Credit spreads continue to bake a blue-sky scenario (solid economic growth and persistent demand for spread products).
- **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** turned positive with 73% of the countries recording gains. The median local currency return was 1.9% (YTD 9%). U.S. Small Caps (10%) led the rally as sentiment flipped spectacularly from large cap, technology, and momentum towards laggards for the year. Nasdaq clocked a return of -1% (YTD 17%). Value and minimum volatility were winning styles. U.S. Reits (6%) made a comeback, riding a spectacular show by Office (16%). Materials, financials and industrials outperformed IT and consumer discretionary stocks.
- **Fixed income**
  - **Policy Rates:** There were four cuts (Canada, China, Colombia, and Hungary) and two hikes (Japan and Russia). Market pricing has moved to significant rate cuts in coming months, which should push our global policy rate indicator towards 4.5% by the end of 2024 from 5.2% currently.

- **Bond Yields:** Our Global Sovereign 10-yr yield indicator crashed -58bps to 3.95%, with every country barring Türkiye experiencing lower yields. Slowing growth and rising rate cut prospects were behind the aggressive move. Yield curves flattened, with the 2-10 U.S. treasury spread ending at -23bps from -36bps.
- **Credit Spreads:** Credit spreads were stable for U.S. investment grade at 93bps but slightly wider at 314bps for U.S. high yield. Demand for spread products remained strong.
- **Returns:** Returns were strong, with duration scoring over spread. Long-end U.S. treasuries gained 4% as yields crashed.
- **Currencies:** The broad trade weighted U.S. Dollar dropped 1% as the greenback was down -2% against developed market currencies. A rate hike by the Bank of Japan caused the Yen to rip 7% against the greenback. Markets priced aggressive rate cuts by the U.S. Fed, which created headwinds for the greenback. However, year till date, the greenback has made gains against every currency barring four (GBP, Ruble, South African Rand, and Malaysian Ringgit).
- **Commodities:** The GS commodity index dropped -5% on growth worries. Precious metals (5%) were the only ones to defy the gloom, rising as U.S. treasury yields collapsed.

## U.S. Property 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 (monthly mortgage servicing costs have jumped 120% between 2021 and 2024 using the 30-yr mortgage rate as proxy). While there are offsets in the form of strong macro factors i.e., low U.S. mortgage debt/GDP of 46% vs 70% pre-GFC, lower home ownership rate (66% vs 69% pre-GFC), and low mortgage rates on existing mortgages (3.9% vs new 30-yr mortgages at 7%), prospective homeowners would dearly welcome a decline in treasury yields which pulls mortgage rates down.
- The commercial property sector remains challenged. However, green shoots could be emerging. Public Reits markets recovered smartly in July, led by the challenged office sector as capital markets started unfreezing primarily due to lower yields. Real Capital Analytics' (RCA) indices showed that commercial property prices were up 2% yoy in June. Industrials gained +8%. Apartment prices were down -7% (peak -14%), while office prices dropped -12% (peak -17%).

## Summary

### 1. Growth

**Neutral from Positive**

We are moving our growth outlook to neutral in recognition of slowing growth. Our global PMI index has contracted for four successive months. U.S. ISM Manufacturing (3-month average 48) and Service Indices (3-month average 50.7) have been soft lately. U.S. employment growth is ebbing, with non-farm payrolls growing at an average of 170k in the last three months versus 218k in the prior period. Job opening and quit rates have peaked, jobless claims are higher, and wage growth has slowed. China's recovery has stalled, with 2Q'24 GDP growing at 4.7%yoy versus 5.3%yoy in 1Q'24. On the other hand, Europe and other Emerging markets are holding up well.

### 2. Inflation

**Neutral**

Softer releases in the last few weeks have raised hope that inflation is headed towards policymaker targets. 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 the one gone by.

### 3. Global financial conditions

**Positive from Neutral**

While credit spreads remain tight, and equity momentum extended, lower interest rates (both policy rates and yields) should help ease overall financial conditions from current levels, which causes us to move this factor to positive.

### 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** remain tight, leaving little room for further compression.

## 5. Technicals

Neutral

Price Momentum weakened for technology and large cap stocks, providing a boost to small cap stocks. Retail investor sentiment was positive but was not in overbought zone (the AAI Bull-Bear spread eased to twelve from sixteen). Market hedging through put options remained near its long-term median. Hedge funds, however, were still running extended net longs in momentum stocks.

## 6. Asset allocation orientation

Neutral

Compressed risk premia keep our stance defensive. 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-

- Uptick in credit card delinquencies as lower income households exhaust excess savings.
- Floating rate borrowers see weaker earnings growth relative to the cost of borrowings.
- 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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