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Multi-Asset perspectives

Courtesy of Principal Asset Management

August 2024

Macro

- **Manufacturing indicators** were weaker. Our global Manufacturing PMI index stayed in contraction for a fifth straight month at 48.7. Though U.S. recovered marginally (47.2 from 46.8), China (49.1 from 49.4) remained weak. Recoveries in Japan (49.8 from 49.1) and Euro Area (47.5 from 47.2) were not strong enough. Rising inventories could present headwinds to manufacturing growth in coming months, unless consumers continue to spend strongly. Our leading regime Indicator remained close to 50, implying borderline growth. Economic Surprises were negative, barring Europe.
- **Global financial conditions** (FCIs) were easier, helped by lower rates, tighter credit spreads and improved monetary growth. Lower rates are likely to ease financial conditions further in coming months.
- **Global inflation** was stable at 3.2%yoy in Jul'24, though seventeen countries recorded higher readings versus five lower. Inflation was 2.5% in developed economies and 4.1% in emerging. U.S. policymakers remain encouraged by recent declines in implied break-even inflation derived from TIPS, with 5-yr at 2.03% and 10-yr at 2.15%.

Bottom-up

- **Global bottom-up earnings revisions** were largely stable. 3-month Earnings Revisions Ratio remained at 49% (41% at the start of the year). Expected earnings growth for 2024 for MSCI AC World ticked up to 11% from 10%, primarily due to a weaker dollar.
- **Global credit rating upgrades** to total changes was stable at 51% relative to 43% at the start of the year. Global IG was at 70% vs. 58% while Global HY was at 40% vs. 35%. While rating momentum for IG is as high as it could possibly be (seven upgrades for three downgrades), that for HY could improve a tad if corporate earnings growth remains strong.

Valuations

- The **U.S. 10-yr treasury yield**, at 3.9% remained just below our model implied fair value range of 4.0-4.8%.
- **U.S. IG spread** was stable at 93bps (29th %ile in history) while HY spread tightened -9bps to 305bps (13th %ile). 30-yr U.S. corporate bond spread moved to 34th %ile (A rated) and 23rd %ile (Baa rated) as long corporate bond spreads tightened on continued investor demand.
- **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** ended with gains following a roller coaster ride that saw markets slump on growth worries (weaker employment data in the U.S. led to a sharp momentum reversal sell-off) but recover smartly with 65% of the countries gaining and producing a median local currency return of 1% (YTD 10%). Emerging markets like Argentina, Brazil, and Indonesia led even as Chinese onshore shares continued their struggles (Shanghai composite had its fourth consecutive negative month at -3%). U.S. Small Caps which had led large caps handsomely in July, lost momentum in both absolute and relative terms, as did the tech-heavy Nasdaq. Minimum Volatility was the best performing style, followed by Quality. U.S. REITs (6%) had another strong month. Office REITs (4%) have outperformed Industrial REITs by 16% since the start of the year in a sharp reversal of sentiment towards the sector which has been in recession for the last 3 years, with a peak-to-current drop in commercial office prices of more than -30% based on the NCREIF property index.
- **Fixed income**
  - **Policy Rates:** There were six cuts (U.K., Sweden, Philippines, Mexico, Peru and Czech Republic), no hike. Our economists are penciling -75bps of cuts by the U.S. Federal Reserve this year, starting in September which should push our global policy rate indicator towards 4.5% by the end of 2024 from 5.1%.

- **Bond Yields:** Our Global Sovereign 10-yr yield indicator softened -5bps to 4.25%, with fifteen countries showing lower yields and thirteen higher. Slowing growth, lower inflation, and rising rate cut prospects remained dominant market themes. Yield curves steepened, with the 2-10 U.S. treasury spread ending at -1bp from -23bps. The term spread should turn positive as rate cuts take effect.
- **Credit Spreads:** Credit spreads moved in tandem with equities, widening initially but recovering to close unchanged at 93bps (U.S. investment grade) but -9bps tighter at 305bps (U.S. high yield). Spread product demand remained strong.
- **Returns**: Returns were strong again. Duration outperformed. Long-end U.S. treasuries gained 2% as yields softened.
- **Currencies**: The broad trade weighted U.S. Dollar dropped -2% due to a softer interest rate outlook. 80% of the currencies we track gained versus the greenback though the Mexican peso dropped -6% on political concerns about market unfriendly constitutional changes and unwind of Japanese funded carry trades which had benefited the peso in the past.
- **Commodities**: The GS commodity index dropped -3% on growth worries. Energy prices continued to see weakness (-6%) as Chinese growth softened. Industrial metals (3%) recovered after dropping -10% in the two months prior. Precious metals (2%) continued their recent run as gold prices touched new highs.

U.S. Property Indicators

- U.S. housing affordability was at 65% of its 15-year average due to high mortgage rates and home prices. While there are offsets through low U.S. mortgage debt/GDP (46% vs 70% pre-GFC), lower home ownership rate (66% vs 69% pre-GFC), and low mortgage rates on existing mortgages (4% vs new 30-yr mortgages at 6.8%), prospective homeowners would dearly welcome further relief. Indeed, high mortgage rates have been a constant headwind to property transactions despite higher prices (Case Schiller 20-city price index was up 6.5% yoy in Jun'24).
- The commercial property sector remains challenged. However, green shoots could be emerging. Public Reits markets recovered further in August. The challenged office sector gained 4% (+60% from its bottom in Oct'23) as capital markets showed further signs of recovery. Real Capital Analytics' (RCA) indices showed that the year-over-year change in commercial property prices was flat during July. Industrials (+9%) remained the clear leaders. Apartment prices were down -8% (trough -14%), while office prices dropped -12% (trough -17%). Encouragingly, office prices were flat for the last four months for both suburban (trough -13%) and CBD (trough -35%).

Summary

1. Growth **Neutral**

We retain a neutral outlook on growth. Our global PMI index has contracted for five successive months. U.S. ISM Manufacturing (3-month average 47.5) and Service Indices (3-month average 51.3) 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. While 2Q'24 U.S. GDP grew strongly at 3% annualized, our economists expect it to taper down towards trend (~2%) in coming quarters. China's recovery has stalled, with 2Q'24 GDP growing at 4.7%yoy versus 5.3%yoy in 1Q'24. While Europe and other Emerging markets are holding up well, their growth contribution will not be enough to compensate for slower growth in U.S., and China.

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**

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

4. Valuations **Negative**

- **Risk-free rates** continue to present meaningful positive yielding anti-fragile alternatives, but rate cuts will start dimming their lure in coming months.
- **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 has weakened for technology stocks though the correction has been rather shallow. Retail investor sentiment moved to an overbought zone (the AAII Bull-Bear spread rose to twenty-four from twelve) in August. Market hedging through put options was below its long-term median though the skew jumped, indicating higher demand for hedges. Volatility targeting and risk-parity strategies are carrying less risk but not sufficient to signal a contrarian risk-on flip. Overall, the technical picture presented a mixed bag, without any clear signals.

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, China-U.S. relationship ahead of U.S. elections).
- Tax rates rise globally as governments try to flatten the income curve and fund their expanding deficits.

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