Multi-Asset perspectives

Courtesy of Principal Asset Management

September 2024

Macro

- **Manufacturing indicators were stable but remained soft.** Our global Manufacturing PMI index stayed in mild contraction for a sixth straight month at 48.6. U.S. was unchanged at 47.2, China improved to 49.8 from 49.1 but Europe eased to 47 from 47.5. Rising inventories could present headwinds to manufacturing growth in coming months. Our leading regime Indicator remained close to 50, implying meagre growth. Economic Surprises were marginally negative across the board. Labor strikes in ports on the east coast and the gulf-coast, which handle almost 40% of U.S. international trade, could create short-term growth headwinds.
- **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 lower at 2.9%yoy in Aug'24, with twenty-one countries recorded lower readings. Inflation was 2.2% in developed economies and 3.8% in emerging. U.S. policymakers remain encouraged by recent declines in inflation.

Bottom-up

- **Global bottom-up earnings revisions** were largely stable. Expected earnings growth for 2024 for MSCI AC World was unchanged at 11%. The 3-month **Earnings Revisions Ratio,** however, eased to 47% from 49%.
- **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 3.8% remained just below our model implied fair value range of 3.9-4.7%.
- **U.S. IG spread, at 89bps was at 25th %ile in history while HY spread tightened -9bps to 305bps (10th %ile).** 30-yr U.S. corporate bond spread moved to 22nd %ile (A rated) and 12th %ile (Baa rated) as long corporate bond spreads tightened further on continued investor interest.
- **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 were not expensive yet but are getting there. Latin America and most parts of Asia remained cheap.

Markets during the month

- **Global Equities** ended with gains for a fifth successive month, propelled by a dovish Fed (-50bps rate cut with promise of more to come). The outsized Fed cut was mainly due to desirable progress on inflation, not necessarily concerns that the economy was stalling. The other big event was a set of big-bang measures by Chinese policymakers to revive investor confidence in real estate and equity markets through lower interest rates, fiscal spending, liquidity to equity market participants, and an equity stabilization fund. Given how poorly Chinese equities have performed in the last few years (U.S.$ 5-year MSCI China return 0.8% annualized vs 15.4% for U.S. and 16.5% for India), the measures were very well received by markets, with onshore and offshore Chinese equities jumping 17-25%. Globally, 68% of the markets gained, producing a median local currency return of 1% (YTD 12%). Minimum Volatility was the best performing style yet again. U.S. Reits (3%) had another strong month with Office Reits rising 6% (YTD'24 22%). Large Caps outperformed in Asia and U.S. but lagged in Japan.

- **Fixed income**
  - **Policy Rates:** There were fifteen rate cuts (U.S. Fed led the way with a cut of -50bps as inflation continued to ease, necessitating a switch in their focus to growth & inflation from just inflation earlier), which pushed our global policy rate indicator to 4.9% from 5.1%. More cuts in 4Q'24 should push it close to 4.5% by the end of the year.
  - **Bond Yields:** Our Global Sovereign 10-yr yield indicator softened -12ps to 4.2%, with twenty-five countries showing lower yields. A dovish Fed and lower inflation were dominant market themes. Yield curves steepened, with the 2-10 U.S. treasury spread ending at 14bps from -1bp. The term spread will steepen further as rate cuts take effect.
  - **Credit Spreads:** Credit spreads tightened some more on positive orientation towards risk assets. U.S. investment grade closed -4bps tighter at 89bps, and U.S. high yield -10bps at 295bps.
  - **Returns:** Returns were strong again. Spread duration outperformed. Long-end U.S. treasuries gained 2% as yields slid.
- **Currencies:** The broad trade weighted U.S. Dollar dropped -1% due to a faster decline in U.S. interest rates. 80% of the currencies we track gained versus the greenback. Asian currencies were boosted by the China's measures to boost sagging markets. With the moves in 3Q'24, the U.S.$ flipped to a small loss versus other DM currencies (DXY Index) for the year.
- **Commodities:** The GS commodity index dropped -1% as energy prices (-5%) continued their recent weakness on increased supplies from OPEC. The rest of the commodity block gained 5%, with precious metals boosted by continued geopolitical tensions in the Middle East and lower interest rates.

U.S. Property Indicators

- U.S. housing affordability remains well below its historical average due to high mortgage rates and home prices, which has impacted home buyer sentiment adversely. At the macro level though, offsets through low U.S. mortgage debt/GDP (46% vs 70% pre-GFC) and low mortgage rates on existing mortgages (3.9% vs new 30-yr mortgages at 6.7%), are keeping the sector in good stead. Low supply of used homes due to higher refinancing costs keep pushing home prices higher (Case Schiller 20-city price index gained 5.9% yoy in Jul'24).
- The commercial property sector remains challenged. However, lower interest rates and noticeable price corrections since 2021 imply that the process of formation of a bottom is probably under way. Indeed, public Reits markets have recovered in the last few months in anticipation of this. The challenged office sector gained 6% in September and is up 66% from its bottom in Oct'23). Real Capital Analytics' (RCA) indices showed that the year-over-year change in commercial property prices has been flat since April'24. On a year-over-year basis, Industrials (+7%) remained the clear leaders. Apartment prices were down -6% (trough -14%), while office prices dropped -10% (trough -17%), with suburban dropping -5% (trough -13%) and CBD -27% (trough -35%).

Summary

1. Growth **Neutral**

We retain a neutral outlook on growth. Our global PMI index has contracted for six successive months. U.S. ISM Manufacturing (3-month average 47.1) and Service Indices (3-month average 50.6) have been soft lately. U.S. employment growth is ebbing though still positive. Job opening and quit rates seem to have peaked, 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. European growth remains lackluster (particularly Germany). The big bang announcements in China are likely to boost asset markets significantly more than their growth trajectory. Other Emerging economies (India, Brazil etc.) are doing well but are unlikely to be able to compensate for normalization of U.S. growth lower.

2. Inflation **Neutral**

Inflation has softened in the last few months. 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 policy rates should 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 have started dimming their lure.
- **Equity Valuations** remain expensive in the U.S. but are reasonable in several emerging markets.
- **Corporate spreads** remain tight, leaving little room for further compression.

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

Price momentum indicators showed equities, Reits, and fixed income to be in an overbought zone by the end of September. Retail investor sentiment towards equities remained in an overbought zone (the AAII Bull-Bear spread rose two points from an already extended twenty-four). Market hedging through put options was near its long-term median though the skew remained high, indicating higher demand for hedges. Volatility targeting and risk-parity strategies have de-risked only marginally and would be forced to cut risk if volatility picks up.

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

Compressed risk premia keep our stance defensive. U.S. large cap equities and global corporate credit are priced for perfection. 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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