Multi-Asset perspectives

Courtesy of Principal Asset Management

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Macro

- **Manufacturing indicators were stable but soft**. Our global Manufacturing PMI index stayed in mild contraction for a sixth straight month at 48.4. U.S. softened to 46.5 from 47.2, Europe to 46.8 from 47.1, though China improved to 50.1 from 49.8. Rising inventories could present headwinds to manufacturing growth in coming months. Our leading regime Indicator remained close to 50.0, implying meagre growth. Economic Surprises turned marginally positive, driven by U.S., China, and Europe. Japan turned negative.
- **Global financial conditions** (FCIs) were tighter, primarily due to higher rates and weaker equity momentum. Lower rates should ease financial conditions in coming months.
- **Global inflation** was lower at 2.7%yoy in Sep'24, as twenty-three countries recorded lower readings. Inflation was 1.9% in developed economies and 3.7% in emerging. European inflation dropped noticeably, setting the ECB on course to cut rates further.

Bottom-up

- **Global bottom-up earnings revisions** were softer. Expected earnings growth for 2024 for MSCI AC World softened to 9% from 11% primarily due to U.S.$ strength. 2025 growth was at 13% from 15%. The 3-month Earnings Revisions Ratio which measures the breadth of earnings changes, eased to 45% from 47% (50% = neutral).
- **Global credit rating upgrades to total changes** was stable at 52% relative to 43% at the start of the year. Global IG was at 68% vs. 58% while Global HY was at 41% vs. 35%. While rating momentum for IG is as high as it could be (almost seven upgrades out of ten changes), that for HY could improve further if corporate earnings remain strong. U.S. remained the strong region.

Valuations

- The **U.S. 10-yr treasury yield**, at 4.28%, moved into our model implied fair value range of 4.1-4.8% from being below it.
- **U.S. IG spread**, at 84bps was at 18th %ile in history while HY spread at 282bps was at 6th %ile. 30-yr U.S. corporate bond spread moved to 14th %ile (A-rated) and 6th %ile (Baa-rated) on continued investor demand due to attractive all-in yields.
- **Global equity valuations remained expensive**. MSCI ACWI was cheaper than current levels 93% of the time in history, driven by expensive U.S. stocks (Large caps). U.S. small caps in the fair value zone. Latin America and Asia ex-India remained cheap.

Markets during the month

- **Global Equities** paused their run of five successive monthly gains. Worries that the recent decline in U.S. inflation was stalling, potentially higher terminal interest rates, and U.S. election uncertainty weighed on market sentiments. The Chinese markets printed red after a heady run-up in September. Globally, only 28% of the markets gained, producing a median local currency return of -2% which shrank YTD'24 median gain to 10%. Momentum was the best performing style for the month, displacing Minimum Volatility. Large Caps were just ahead of small caps globally. U.S. Reits (-3%) underperformed as Industrials dropped noticeably. Office Reits rose 2% (25% YTD'24).
- **Fixed income**
  - **Policy Rates:** There were nine rate cuts and a hike (Russia, +200bps) which kept our global policy rate indicator unchanged at 4.9%. More cuts are expected in 4Q'24 that should push the metric to 4.50-4.75% in 4Q'24.

- **Bond Yields**: Our Global Sovereign 10-yr yield indicator jumped 30bps to 4.5%, with yields higher in twenty-five countries in a sharp reversal of the bullish sentiment prevailing till September (five months of successive declines). Fiscal worries post U.S. elections, a marginal uptick in inflation, and continued strength in the U.S. economy (3Q'24 GDP grew well above trend at 2.8% QoQ annualized) raised the specter of a higher neutral policy rate than previous market expectations. Yield curves were marginally flatter, with the 2-10 U.S. treasury spread ending at 11bps from 14bps.
- **Credit Spreads**: Credit spreads tightened some more on continued strong demand for fixed income assets. U.S. investment grade closed -5bps tighter at 84bps, and U.S. high yield -13bps at 282bps.
- **Returns**: Returns were negative for bonds other than floaters (leveraged loans and CLOs), driven by higher sovereign yields. Spread duration outperformed. Long-end U.S. treasuries crashed -5%.

- **Currencies:** Soaring U.S. yields and rising expectations of a Trump victory who is likely to pursue a U.S. centric trade policy made it a home run for the greenback with gains against every currency we track it against. The broad trade weighted U.S. Dollar gained 3%. The worst performer was Chilean Peso (-7%). Best performers were Turkish Lira, Indian Rupee, and Taiwan $ that had drops of less than -0.5% each.
- **Commodities:** The GS commodity index was broadly unchanged, with continued gains in precious metals (4%) and a mild recovery in energy (1%) wiped out by losses in agriculture (-4%) and industrial metals (-3%). Middle East tensions remained high, but Israel stayed away from bombing Iranian oil facilities, which kept oil prices in check, despite significant intra-month volatility. Oil prices (brent) have dropped -16% yoy.

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), high home equity (~75%), and low mortgage rates on existing mortgages (4% vs new 30-yr mortgages at 7.3%), are keeping the sector in good stead. Low supply of used homes due to high refinancing costs (existing home sales are at a multi-year low) are supporting home prices (Case Schiller 20-city price index gained 5.2% yoy in Aug'24 relative) though the pace of increases is slowing.
- The commercial property sector remains challenged but there are signs that the bottoming out process may have started after noticeable price corrections since 2021. Public Reits markets which tend to lead private markets by 12-18 months, have recovered in the last few months. The challenged office Reits sector gained another 2% in October and is up 68% from its bottom in Oct'23. Real Capital Analytics' (RCA) indices showed that prices have been stable since 1Q'24 for offices (slightly higher for suburban offices but lower for CBD) and retail, higher for industrials but lower for multi-family residential. Interest rates hold the key. If the U.S. federal reserve cuts rates to somewhere between 3-4% next year, it should draw investor and developer capital into the sector.

Summary

1. Growth — Neutral

We retain a neutral outlook on growth. Our global PMI index has contracted for six months. U.S. ISM Manufacturing (3-month average 47) has softened lately. While Services are still holding the forte, volatility has increased. U.S. employment growth is positive but ebbing (non-farm payroll growth has slowed from ~2% in 1Q'24 to about 1.5% in 3Q'24). Job opening and quit rates seem have peaked, and wage growth has slowed. While 3Q'24 U.S. GDP grew strongly at 2.8% annualized, our economists expect it to taper down towards trend (~2%) in coming quarters. European growth remains lackluster, as Germany continues to struggle. The big bang announcements in China are likely to boost asset markets significantly more than their growth trajectory. Other Emerging economies like India are doing well but are unlikely to be able to compensate for the normalization of U.S. growth lower.

2. Inflation — Neutral

Inflation has softened since the start of the year but the path towards the 2% goal of developed economy central banks is turning out to be bumpy in the near term. 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 potentially higher inflation.

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 would dim their allure.
- **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** **Neutral from Negative**

The correction in equities in October has reduced momentum froth from equities and rates, though credit momentum remains extended. Retail investor sentiment towards equities softened (the AAII Bull-Bear spread dropped to nine from twenty-six). Market hedging through put options edged up but remained near its long-term median. Volatility targeting and risk-parity strategies, who have de-risked marginally, would be forced to cut more materially if volatility gets elevated.

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. Our models suggest U.S. consumers have used up $1.6bn out of the $2.3bn of accumulated excess savings following the pandemic.
- 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).
- Tax rates rise globally as governments try to flatten the income curve to fund expanded budget deficits.

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