Multi-Asset perspectives

Courtesy of Principal Asset Management

December 2024

Macro

- **Manufacturing indicators ticked up slightly.**
  - Our global Manufacturing PMI index stayed in mild contraction for a seventh straight month at 49.1. U.S. improved to 49.3 from 48.4 but both China (50.1) and Europe (46.2) were softer.
  - Our leading regime Indicator ticked up to 50.8, implying moderate growth. The likelihood of tariffs under the Trump administration is providing a near-term boost to manufacturing activity.
  - Economic Surprises were positive in Japan, negative in China and Europe, and in line with expectations in U.S.
- **Global financial conditions** (FCIs) were tighter due to higher rates, wider credit spreads and weaker equity momentum. U.S. financial conditions tightened the most.
- **Global inflation** was stable at 2.8%yoy in Nov'24 (3.4% in Dec'23), with sixteen countries recording higher readings, and nine lower. Inflation was 2.3% (+0.2%) in developed economies and 3.7% (-0.1%) in emerging. Adverse base effects and potential tariffs would make it harder for inflation to decline from current levels in the near term.

Bottom-up

- **Expected earnings growth** for 2025 for MSCI AC World was at 12% with S&P 500 at 15% compared to 7% and 9% respectively for 2024. IT (28%), Health Care & Materials (18% each) are expected to drive earnings growth with Energy (3%), Staples & Utilities (5% each) and Financials (7%) being the laggards. It would require both topline growth and solid margin expansion for expectations to be met.
- **Global credit rating upgrades to total changes** were a tad softer at 50% but significantly stronger than 43% at the start of the year. Global IG was at 66% vs. 58% while Global HY was at 40% vs. 35%. Rating momentum for both IG and HY remains at levels which are hard to improve upon outside of recoveries from recessions.

Valuations

- The **U.S. 10-yr treasury** yield, at 4.6%, was at the upper end of our model implied fair value range of 3.7-4.7%.
- **U.S. IG Index** spread finished at 16th %ile in history and HY index spread at 7th %ile. The picture was similar for ultra-long spreads (30-yrs), where both A-rated and BBB-rated finished at the 8th percentile.
- **Global equity valuations remained expensive.** MSCI ACWI was cheaper than current levels 94% of the time in history, driven by expensive **U.S. stocks remain as expensive as they have ever been relative to ex-U.S. stocks.** U.S. small caps moved back into fair value zone after a month of losses in December. Latin America and Asia ex-India remained cheap.

Markets during the month

- **Global Equities** took a breather after rallying strongly post U.S. elections. Profit-taking amidst concerns about tariffs, higher bond yields and year-end related tax selling pushed S&P 500 to a drop of -3%. Small caps bore the brunt, with Russell 2000 at -8%, which wiped out 90% of its post-election gain. The tech heavy Nasdaq, however, closed with a 1% gain, which put its 2024 return at a lofty 29%, driven by strong gains in heavyweights like Nvidia (171%), Netflix (83%), Meta (66%), Tesla (63%) and Amazon (44%). Other U.S. indices like the Dow (13%), Russell 2000 (10%) and equal-weighted S&P (11%) showed more modest returns. Global equities ex-US delivered a meagre 6% return in U.S. Dollar terms as Europe barely got into positive territory. Growth and Momentum styles outperformed. Large Caps easily beat small caps. U.S. Reits (9%) had a decent year, with office (21%) seeing investor interest on signs of a bottoming out of the sector. Higher rates, could, however, prolong the recovery.

- **Fixed income**
  - **Policy Rates:** Brazil hiked +100bps due to continued inflation concerns while eleven other banks including the U.S. Fed cuts rates, taking our global policy rate indicator to 4.7%.

  - **Bond Yields:** Our Global Sovereign 10-yr yield indicator jumped 18bps to 4.5%, with yields higher in 86% of the countries we track. While the U.S. Fed did cut its policy rate, it sent a hawkish message with the dot plot indicating just two more cuts in 2025 which sent yields soaring. Yield curves ended steeper, with the 2-10 U.S. treasury spread at 33bps versus 2bps.

  - **Credit Spreads:** Credit spreads widened a tad, with U.S. IG +2bps at 80bps, and HY +21bps at 287bps. For the year, IG tightened -19bps, and HY -36bps.

  - **Returns:** Returns were negative across most categories with spreads wider and yields higher. For the year, returns favored spread products with sovereign duration struggling in the face of higher yields.

- **Currencies:** Expectations of a mercantilist trade agenda and hawkish cues by the U.S. Fed sent the greenback to gains against 90% of the currencies we track it against. The broad trade weighted U.S. Dollar gained 2%, taking its gain for the year to 8%. The greenback ended the year even more expensive than at the start, but the current backdrop remains supportive for the first half of 2025.
- **Commodities:** The GS commodity index gained 2%, helped by energy prices (OPEC delayed increasing their output considering lower prices) which rose 5%. For the year, while the overall index was hardly changed, precious metals rallied 27%, which was even more impressive considering broad based U.S. Dollar strength.

U.S. Property Indicators

- U.S. housing affordability remains well below its historical average due to high mortgage rates and higher home prices. 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 7.1%), are keeping the sector in good stead. Low supply of used homes due to high refinancing costs are keeping home sales depressed. Home prices remain supported though the pace of increases is slowing. 2025 could turn out to be a year of muted price increases.

- The commercial property sector remains challenged but there are continued signs that a bottoming-out process is under way after noticeable price corrections since 2021. While rising interest rates could provide fresh headwinds, Public Reits markets which tend to lead private markets by 12-18 months, have recovered in the last few months. Real Capital Analytics' (RCA) indices showed that prices have been stable since 1Q'24 for offices (slightly higher for suburban, slightly lower for Central Business Districts, CBD). Multi-family oversupply should work itself out this year as new construction remains low. On the other hand, industrials, which have seen consistent price increases, could see a more subdued price increase.

Summary

1. Growth — Neutral

U.S. GDP growth should taper down towards trend (~2%) in coming quarters from the current 2.5-3% range. Global manufacturing PMIs have been in lackluster (< 50) for eight months though activity seems to have picked up in the U.S. where new orders have recovered. ISM Services has shown volatility lately but is still suggesting solid expansion. U.S. employment growth remains positive but is ebbing (growth has slowed from ~2% in 1Q'24 to ~1.5% in 3Q'24). While total nominal wage growth has slowed, real wage growth has ticked up due to lower inflation. European growth remains lackluster. Potential trade tensions with the U.S. could weaken business confidence. In China, we expect the Govt. to keep injecting monetary and fiscal stimulus to sustain GDP growth around 5% but structural challenges (adverse demographics, a more hostile trade environment in the developed world) will pressurize the medium-term growth outlook.

2. Inflation — Neutral

After making solid progress towards the 2% goal in developed economies, the last mile is proving more challenging, with demand staying strong and services/housing prices staying resilient. Tariffs when the new Trump administration takes over will not help either. From a longer- term perspective, greenification costs, peaking of China's working age population, rejigging of global supply chains and expansionary fiscal policies point towards potentially higher inflation.

3. **Global financial conditions** **Neutral**

With credit spreads very tight, equity momentum extended, and the projected path for U.S. policy rates shallower than before, we are lowering this factor to neutral from positive.

4. **Valuations** **Negative**

- **Risk-free rates** continue to present positive yielding anti-fragile alternatives.
- **Equity Valuations** are super expensive in the U.S. but remain reasonable in most emerging markets.
- **Corporate spreads** are at multi-year tights.

5. **Technicals** **Neutral**

The December softness in equities reduced froth. Retail investor equity sentiment was neutral (the AAII Bull-Bear spread was at 4). Price momentum measures were not flashing red anymore. However, market hedging through put options remained below long-term median and credit momentum remained extended with spreads near multi-year tights. Volatility targeting and risk parity strategies pared risk as volatility ticked up. Overall, Technicals were a mixed bag, causing us to rate this factor as neutral.

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

Very tight risk premia keep our stance defensive. U.S. large cap equities and global corporate credit are priced for perfection. On the other hand, the U.S. growth remains solid which is preventing us from going underweight risk assets. Key sources of frustration for risk assets could come from:

- Geopolitical risks build up as the new U.S. administration implements a hawkish mercantilist agenda.
- Credit card delinquencies tick up as lower income households exhaust excess savings. Our models suggest U.S. consumers have used up $1.8bn 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.
- Tax rates rise globally as governments try to flatten the income curve to fund expanded budget deficits.

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