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Multi-Asset perspectives

Courtesy of Principal Asset Management

November 2024

Macro

Manufacturing indicators ticked up slightly.

- Our global Manufacturing PMI index stayed in mild contraction for a seventh straight month at 49.0 but showed a slight sequential improvement. U.S. improved to 48.4 from 46.5, China to 50.1 from 50.3 but Europe eased to 46.4 from 47.3.
- Our leading regime Indicator remained close to 50.0, implying meagre growth. However, the possibility of tariffs on imports could result in better manufacturing activity in coming weeks.
- Economic Surprises were negative in U.S. and Japan, but positive in China and Europe.

- **Global financial conditions** (FCIs) were easier due to lower rates, tighter credit spreads and better equity momentum.
- **Global inflation** was one-tenth higher at 2.8%yoy in Oct'24, with fifteen countries recording higher readings, and twelve lower. Inflation was 2.1% in developed economies and 3.7% in emerging. Adverse base effects would make it harder for inflation to decline from current levels in coming months, as predicted by our leading indicator.

Bottom-up

- **Bottom-up earnings revisions** were mixed. Expected earnings growth for 2024 for MSCI AC World softened to 8% from 9% primarily due to U.S.$ strength. 2025 growth was at 12% from 13%. The 3-month Earnings Revisions Ratio which measures the breadth of earnings changes, was stable at 45% (neutral = 50%).
- **Global credit rating upgrades to total changes** was stable at 51% relative to 43% at the start of the year. Global IG was at 68% vs. 58% while Global HY was at 41% vs. 35%. Rating momentum for both IG and HY remains at the higher end for periods outside of recoveries from recessions.

Valuations

- The **U.S.** 10-yr treasury yield, at 4.17%, remained within our model implied fair value range of 4.0-4.8%.
- U.S. IG Index spread, at 78bps was at 15th %ile in history while HY index spread at 266bps was at the 3rd %ile. 30-yr U.S. corporate bond spreads widened a tad, moving to 109bps, 36th %ile (A-rated) and 137bps, 19th %ile (Baa-rated).
- Global equity valuations remained expensive. MSCI ACWI was cheaper than current levels 96% of the time in history, driven by expensive **U.S. stocks that have never been more expensive relative to ex-U.S. stocks.** U.S. small caps also moved out of fair valuezone into the expensive zone after a strong November rally. Latin America and Asia ex-India remained cheap.

Markets during the month

- **Global Equities** rallied as U.S. elections brought a clean sweep for the GOP. President Trump won 312 electoral college votes versus the required 270, polling 50% of the votes to Kamala Harris's 48.4%. The GOP gained an extra four seats to win the Senate 53:47, and retained a slim majority in the House, winning 220 of the 434 seats declared (one seat is still to be declared). Markets gave a thumbs up to Trump's promised agenda of deregulation, lower taxes, and a U.S. first international policy built on hard trade negotiations. While U.S. equities rallied (S&P 500 +6%, Russell 2000 +11%), almost half the international markets closed in the red on worries relating to U.S. trade policy. That suppressed the global median local currency return to almost zero. Chinese offshore markets struggled as investors continued to take chips off the table after the strong 3Q'24 rally. China could get caught in the trade storm that the new administration is likely to unleash. Growth and Momentum styles outperformed. Large Caps lagged small caps globally. U.S. Reits (4%) underperformed broader equity markets. Office Reits rose 2% (28% YTD'24, the same as S&P 500).

- **Fixed income**
  - **Policy Rates:** Brazil hiked +50bps due to inflation concerns while nine other banks cuts rates, taking our global policy rate indicator to 4.8%. A -25bp cut by the U.S. Fed in December remains very much in play.
  - **Bond Yields:** Our Global Sovereign 10-yr yield indicator eased -13bps to 4.4%, with yields higher in 86% of the countries we track. While worries remain about U.S. fiscal policy and inflation outlook (due to tariffs and continued growth), the recent jump in yields (U.S. 10-yr from 3.75% to 4.25%) seems to capture those. Yield curves were flatter, with the 2-10 U.S. treasury spread ending at 2bps from 11bps.
  - **Credit Spreads:** Credit spreads tightened some more, with U.S. IG -5bps at 78bps, and HY -16bps at 266bps.
  - **Returns:** Returns were positive with both spreads (tighter) and yields (lower) contributing to price returns.
- **Currencies:** Expectations of a U.S. first mercantilist agenda sent the greenback higher against global currencies, with gains against all barring the JPY which rallied on cues that the Bank of Japan will be forced to hike rates. The broad trade weighted U.S. Dollar gained 2%, making the greenback even more expensive than before.
- **Commodities:** The GS commodity index was broadly unchanged, with a gain of 3.5% in agricultural commodities washed out by a correction of -2% in precious metals, though gains for the year stood at a strong 29% for the sub-sector.

U.S. Property Indicators

- U.S. housing affordability remains well below its historical average (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.
- 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. 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 offices but lower for CBD) and retail, higher for industrials but lower for multi-family residential (mainly due to increased supply). If the U.S. federal reserve keeps cutting rates next year, investor and developer capital should get drawn into the sector, hastening the recovery process.

Summary

1. Growth **Neutral**

Our economists expect U.S. GDP growth to taper down towards trend (~2%) in coming quarters from the current 2.5-3% range. Our global PMI index has contracted for seven months though activity seems to be picking up in the U.S. where ISM Manufacturing (3-month average 47.4) has ticked up lately, driven by a recovery in new orders. ISM Services has recovered too with the 3-month average at 52.6. 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 further into the new year. The recent big bang announcements in China are positive but unlikely to boost growth significantly.

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 bumpier in the near term. Adverse base effects raise the bar somewhat in coming weeks. From a longer- term perspective, greenification costs, peaking of China's working age population, rejigging of global supply chains, 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 retain this factor as positive. A risk to this would be if the new U.S. administration's policies are inflationary, leading to the Fed not cutting rates beyond 2024 (markets are pricing three cuts in the next twelve months).

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

- **Risk-free rates** continue to present positive yielding anti-fragile alternatives, but rate cuts would dim their allure.
- **Equity Valuations** got even more expensive in the U.S. but remained reasonable in several emerging markets. US has never been as expensive relative to other markets.
- **Corporate spreads** have narrowed to multi-year tights.

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

The November rally in U.S. equities extended their momentum considerably, putting them in an overbought zone. Credit momentum remains extended with spreads at multi-year tights. Market hedging through put options moved below long-term median. Volatility targeting and risk-parity strategies have added back risk as volatility ebbed. However, retail investor equity sentiment remains neutral (the AAII Bull-Bear spread dropped to -2 from 9).

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, prospects for easier financial conditions and reasonable earnings growth prevent us from going underweight risk assets either. 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 $1.7bn 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.

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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