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3Q 2022

Global Asset Allocation Viewpoints

Reaching fever pitch

Principal®

Investment themes

The stars align for the perfect market storm

The global economy and financial markets have suffered a dreadful first half of the year, ravaged by a severe commodity shock, strict COVID-19 lockdowns in the world's second largest economy, and one of the most aggressive Fed tightening cycles in recent history. The second half looks equally tough.

Consumers, already struggling with higher food and energy prices, are now being confronted by rapidly rising mortgage borrowing costs. Corporations, which have been able to pass on elevated input costs in recent months, are now facing an increasingly price-sensitive consumer, with negative implications for profit margins and earnings.

And now, in its bid to put inflation back in its cage, the Fed is no longer avoiding economic weakness, rather, it is targeting additional economic weakness. A U.S. recession in 2023 is now our baseline expectation.

Playing defense: Quality and stability

Global monetary easing has become global monetary tightening. Global growth is transitioning to global recession. Earnings beats will likely soon be earnings disappointments. With the familiar playbook of easy financial conditions supporting risk assets turned upside down, investors need to revisit portfolios and positioning with fresh eyes.

It will be crucial for investors to refocus on high quality, seeking out assets that can potentially still deliver stable earnings even as the growth landscape becomes dry and barren. Most importantly, and now maybe more than ever, the importance of diversification cannot be exaggerated.

Investing in *real* time

Traditional equity and fixed income classes will be challenged in this low growth, high inflationary environment. By contrast, real assets are typically less sensitive to inflation (or even thrive in inflationary environments), offer more predictable cash flows, and therefore can potentially flourish in this investment landscape, providing important diversification benefits and inflation mitigation.

Investors may be concerned that, like so many post-Global Financial Crisis and post-COVID winners, real asset gains are starting to run dry. However, structural shortages should continue to support commodity returns, while infrastructure provides opportunities to access attractive long-term investment themes, such as decarbonization, which will likely outlast Fed tightening and recession concerns.

Consider the potential risks

Sizeable energy disruption: An escalation in the geopolitical conflict that results in a sustained cut-off in Russian energy supply would not only push global energy prices and inflation even higher, but it would also generate an acute stagflationary economic shock to the global economy, prolonging and deepening a recession.

Fed policy mistake: Although the market may be concerned that the Fed will hike too far, there is a risk it instead capitulates to market fears and stops tightening too early.
While markets may initially respond positively, inflation and inflation expectations would likely resume a sharp upward path, enhancing the Fed's task. In that event, the Fed would need to hike even more than in the current trajectory.

INVESTMENT IMPLICATIONS

Equities

Reduce risk appetite and focus on U.S. high quality factors

Position towards certainty and stability:

- Exposure to quality within equities can potentially offer risk mitigation during pullbacks.
- U.S. continues to be most favorable region for equities.
- U.S. mid-cap offers stronger geographical revenue exposure and more attractive valuations.

How to implement:

- Mid-cap strategies
- Quality-biased active managers

Fixed Income

Time for defense

Core fixed income and preferred securities:

- Core fixed income to hide out in as recession risk rises; high yield spreads to widen further
- Recommend slightly increasing duration bias across the asset class.
- Infrastructure spending could boost an increase in municipal bond offerings.
- Preferred securities provide potential yield and exposure to high quality

How to implement:

- Preferred securities strategies
- IG credit heavy core fixed income for stability
- Municipal bond strategies

Alternatives

Pursue less correlated real asset exposures.

Real assets:

- Real return-focused strategies gain attractiveness when nominal growth slows.
- Expect real assets outperformance to extend as structural commodity shortages support prices through economic downturn.
- Infrastructure offers more stable cash flows with potentially attractive yield.
- Real assets can help mitigate inflation risk.

How to implement:

- Diversified real asset strategies (infrastructure, natural resources)
- Private real estate markets

IMPORTANT INFORMATION

Risk considerations

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