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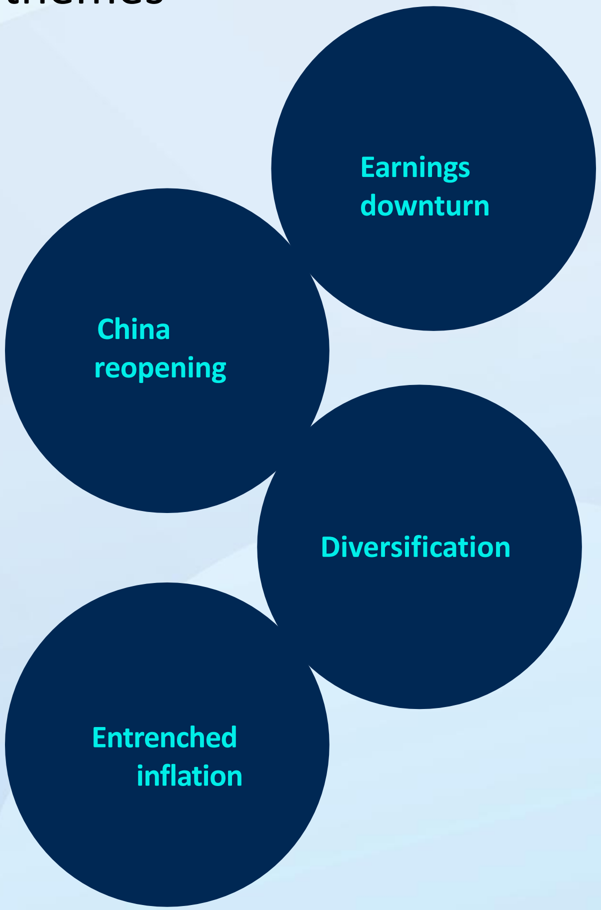
Global Asset Allocation Viewpoints

Half agony, Half hope

Principal®

Investment themes



From inflation concerns to growth concerns

Now that inflation is on a decelerating path, 2023 may not see a repeat of the frantic Federal Reserve (Fed) activity that characterized 2022. Yet, the slow and sticky nature of the inflation decline implies that policy rates almost certainly still have further to rise.

While it may not be evident yet, the most aggressive monetary tightening cycle since the 1980s will leave a visible imprint on the U.S. economy, with recession taking shape in the second half of 2023. Unfortunately, as history warns against prematurely calling victory over inflation, relief from the Fed will not be forthcoming. After reaching a peak rate of 5.25-5.5% in the first half of the year, Fed policy will have to remain restrictive throughout 2023—even as the U.S. economy falls into recession. Against this backdrop, broad equities will likely remain challenged.

China: Unleashing the dragon

After two years of economic weakness, recent steps to ease China's zero-COVID policy are filling investors with optimism.

A full reopening will not happen overnight. Yet a roadmap for an end to China's stringent COVID-19 measures should eventually provide the catalyst for a rebound in Chinese economic activity. The sustainability of the rebound and its potential positive impact on China's major trading partners across Europe and Asia, however, will likely depend on Chinese policymakers' resolve to add effective stimulus measures.

For much of 2023, U.S. economic challenges will likely inhibit significant risk taking. In such an environment, emerging market risk assets usually struggle. But, if China is able to reopen smoothly and stimulate the economy, emerging markets should prove resilient against the headwinds.

Diversification is back in vogue

Unlike 2022, where stocks and bonds fell together, opportunities will likely be more forthcoming in 2023. While persistently restrictive monetary policy and the likely resulting U.S. recession will weigh on the broad equity market outlook, the relatively attractive valuations outside the U.S. suggest investors stand to gain through global diversification.

Fixed income's diversification potential has also been restored. With many central banks nearing the completion of their tightening cycles, bonds may be able to support portfolios, providing income and more stability during periods of volatility and risk. Importantly, credit now offers more attractive yields than in recent years, meriting portfolio allocation.

Finally, with price pressures easing very slowly, inflation mitigation via real assets remains a key part of the playbook.

Consider the potential risks

Entrenched inflation: While the market appears to agree that inflation will fade this year, history suggests that there is a risk that meaningful inflation decline may not materialize. In such an event, after a short pause, the Fed and other central banks may need to resume policy hikes. Not only would that deliver additional headwinds to growth, but the negative shock to investor sentiment could set markets on a path to a deeper, more prolonged downturn.

Financial instability: The drastic rise in rates risks severe liquidity disruption. Violent, sudden price moves in one market can provoke a vicious loop of margin calls and forced sales of other assets, with unpredictable results. Markets have so far navigated the rate increases with minimal disruption, but there is no guarantee that 2023 will be as straightforward.

Equities *Reduce risk appetite and focus on U.S. mid-cap sector and quality factor*	**Position towards certainty:** • Exposure to quality within equities can potentially offer risk mitigation during pullbacks • Attractive international valuations suggest opportunities outside the U.S. • U.S. mid-cap offers stronger geographical revenue exposure and more attractive • valuations.	**How to implement:** • Mid-cap U.S. strategies • Quality-biased active managers • Well-diversified strategies across DM and EM markets
Fixed Income *Increase exposure to high quality credit*	**Core fixed income and preferred securities:** • Core fixed income to hide out in as recession risk rises • Recommend increasing duration bias across the asset class • Preferred securities provide potential yield and exposure to high quality	**How to implement:** • IG credit heavy core fixed income for stability • Preferred securities strategies • Agency MBS strategies
Alternatives *Pursue less correlated real asset exposures.*	**Real assets:** • Real return-focused strategies gain attractiveness when nominal growth slows. • 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

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Asset allocation and diversification do not ensure a profit or protect against a loss. Equity investments involve greater risk, including higher volatility, than fixed-income investments. Fixed-income investments are subject to interest rate risk; as interest rates rise their value will decline. International and global investing involves greater risks such as currency fluctuations, political/social instability and differing accounting standards. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. Non-investment grade securities offer a potentially higher yield but carry a greater degree of risk. Risks of preferred securities differ from risks inherent in other investments. In particular, in a bankruptcy preferred securities are senior to common stock but subordinate to other corporate debt. Emerging market debt may be subject to heightened default and liquidity risk. Risk is magnified in emerging markets, which may lack established legal, political, business, or social structures to support securities markets. Small and mid-cap stocks may have additional risks including greater price volatility. Treasury inflation-protected securities (TIPS) are a type of Treasury security issued by the U.S. government. TIPS are indexed to inflation in order to help investors from a decline in the purchasing power of their money. As inflation rises, rather than their yield increasing, TIPS instead adjust in price (principal amount) in order to maintain their real value. Inflation and other economic cycles and conditions are difficult to predict and there Is no guarantee that any inflation mitigation/protection strategy will be successful.

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