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1Q 2024

Global Asset Allocation Viewpoints

Gentle slope, not cliff edge

Principal Asset Management℠

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Key themes for 1Q 2024

- **Global growth is coming off the boil.**
  Economic growth is now cooling as global monetary tightening gradually takes its toll. U.S. recession risk has diminished, although consumer headwinds are rising. China and Europe are likely to see another year of tepid growth.
- **Global disinflation continues unabated.**
  Price pressures have eased significantly, largely due to resolved supply chains. The last mile of disinflation toward central bank targets will require some economic slowdown and job market weakness.
- **A central bank pivot is upon us.**
  Most central bankers have now adopted a more dovish stance and rate cuts are likely in 2024. Yet, they may come slightly later than markets anticipate and will likely be gradual—unless economic growth surprises to the downside.
- **Equities will likely see volatility in H1 followed by a rally in H2 as policy easing arrives.**
  Falling bond yields have driven a sharp market rally, but this can only be sustained if earnings deliver. An economic slowdown in H1, coupled with slightly later than expected rate cuts, suggest some volatility.
- **Fixed income credit spreads are very tight going into an economic slowdown.**
  Rate cuts failing to materialize may drive extended U.S. Treasury disappointment in 1Q. Higher-quality credit should perform better than lower-quality credit as the economy slows, and as the maturity wall becomes more pressing.
- **Alternatives provide important diversification against traditional equities and fixed income.** Commodities are facing an unclear near-term future as investors weigh up geopolitical risks versus greater U.S. oil supply. With real bond yields likely having peaked, REITs are facing a much brighter outlook.

Investment themes

Pause and pivot

The wall of cash

A new regime

Inflation risks and financial market stress

Central bank policy: Pause and pivot

Most global central banks have come to the end of their tightening cycles. Policymakers are eyeing the disinflation progress with great interest, gearing up for policy rate cuts as inflation approaches central bank targets. The last mile of inflation deceleration will not be straightforward. If economic growth remains above trend, price pressures will threaten to re-emerge. So, a cooling in economic momentum and a softening in labor market dynamics are required to ensure inflation is on a sustainable path back to target.

Although the market believes the Federal Reserve (Fed) will be ready to ease policy as soon as March, today's resilient economic backdrop suggests it may take slightly longer, around mid-year, before policymakers feel confident that the inflation genie is back in the bottle. Nonetheless the more important message is that there is a path to monetary easing in 2024. Uncertainty around the exact timing of cuts will add volatility, but it will not change the trend.

The wall of cash

The macro and market backdrop has been confusing over recent years, prompting many investors to flee to money market funds (MMFs), attracted by their higher-than-normal returns, as well as the additional stability they offer. 2024 should see many of the concerns and questions of recent years finally resolved. The long-awaited downturn should arrive and depart without leaving much destruction, inflation should continue to decelerate and, most importantly, the Fed is likely to open the door to rate cuts, reducing the attractiveness of MMFs. The substantial pool of cash currently being harvested in MMFs (almost $6 trillion) is poised to fuel a significant rally in risk assets, offering investors an opportunity to capitalize on improved sentiment and market dynamics.

A new regime

The post-GFC years characterized by sub-target inflation, quantitative easing and fiscal conservatism have evolved into a regime where above (as well as below) target inflation is possible, central bankers actively avoid ultra-easy policy, and fiscal stimulus is recognized as an effective policy tool. The broader financial system will take some time to adjust to this new regime given the upward impact on the cost of capital. Disorder and volatility in low quality credit is likely—bad management, zombie companies and over-exuberance will likely be gradually exposed.

For investors, equities should still benefit from reflationary conditions, although an enhanced screening process is important. Bonds will likely still preserve portfolios in disinflation shocks but will not help in inflationary shocks, so real assets will remain an important part of a portfolio. The new regime calls for investors to actively diversify, taking full advantage of the toolkit in the years ahead.

Consider the potential risks

Resurgent inflation: If economic growth fails to slow, it risks igniting a resurgence in price pressures. Central banks would have to respond by resuming policy tightening, tipping economies into deep downturns. Even worse, if growth slows but rising energy prices result in a de-anchoring of inflation expectations, central banks would still need to respond to the stagflationary environment by hiking rates further.

Financial market stress: Previous monetary tightening cycles have ended in financial turmoil. Despite economic and market resilience, investors should be alert to the elevated risk of financial markets stress, particularly if the impending credit maturity wall coincides with a renewed rise in bond yields.

Equities

Reduce risk appetite and focus on U.S. large-cap and quality factor.

Position toward certainty:

- Exposure to quality within equities can potentially offer risk mitigation during pullbacks.
- Attractive international valuations suggest opportunities outside the U.S.
- Favorable valuations in U.S. small-cap and mid-cap stocks.
- Position for potential equity market rallies in latter 2024 after Fed pivot.

How to implement:

- Large-cap U.S. strategies
- Well-diversified and active international managers
- Quality-biased active managers
- Active mid- and small-cap strategies

Fixed income

Increase exposure to high-quality credit.

High-quality, core fixed income and total return positioning:

- Core fixed income to hide out in during a mild slowdown.
- Increasing duration bias across the asset class.
- Emerging market debt may offer total return potential with central bank easing.
- High yield maintains a substantial carry advantage for income-seeking investors.

How to implement:

- IG credit heavy core fixed income
- Agency MBS strategies
- Flexible emerging market debt strategies
- Active high yield strategies

Alternatives

Pursue less correlated real asset exposures.

Real assets:

- Real return-focused strategies gain attractiveness when nominal growth slows.
- Infrastructure offers resiliency, inflation mitigation, and attractive valuations.
- A mild slowdown should keep demand elevated broadly.
- REITs offer attractive valuations and constructive fundamentals.

How to implement:

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

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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