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2Q 2024

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Global Market Perspectives

What’s not to like?

Principal Asset Management℠

PRINCIPAL GLOBAL INSIGHTS TEAM

Seema Shah
Chief Global Strategist

Brian Skocypec, CIMA
Director, Global Insights & Content Strategy

Ben Brandsgard
Insights Strategist

Key themes for 2Q 2024

- **The U.S. economy stands out from the crowd.**
  U.S. growth is downshifting somewhat as lower income households pull back, and corporates face higher refinancing costs. However, with most other global economies still struggling, the U.S. will remain the strongest global performer.
- **Global disinflation is showing signs of stalling.**
  After having made significant progress last year, inflation deceleration has flattened out. The last mile of disinflation toward central bank targets will require some economic slowdown and job market rebalancing.
- **Central banks believe they can cut rates without sacrificing inflation.**
  The Fed wants to cut policy rates, but it may be fazed by recent inflation surprises. It will likely cut policy rates two times this year, starting in September. Other central banks will also begin easing soon but will cut with greater urgency.
- **Equities should continue embracing the soft landing narrative.**
  The constructive backdrop of solid growth, positive earnings and prospective rate cuts has been fueling market optimism. This mix should also support a broadening of the market rally as rate cuts come closer into sight.
- **Fixed income yields are attractive compared to equity yields.**
  U.S. Treasury yields should skew lower as the Fed begins cuts but will be limited by the shallow easing cycle. While credit spreads are tight, providing recession is avoided, they should not widen much and still provide meaningful carry opportunities.
- **With potential gains across asset classes, staying in cash is the main risk.**
  Assets in money market funds have ballooned to a record $6 trillion, with investors attracted by elevated yields. Now, this cash represents a potential tailwind to risk assets.

Global equity valuations: Pockets of opportunity

The U.S. market was not the only one hitting new record highs. Europe hit an all-time high despite its weak economy, while Japan's Nikkei 225 regained its previous 1989 record high as companies benefitted from a weak yen.

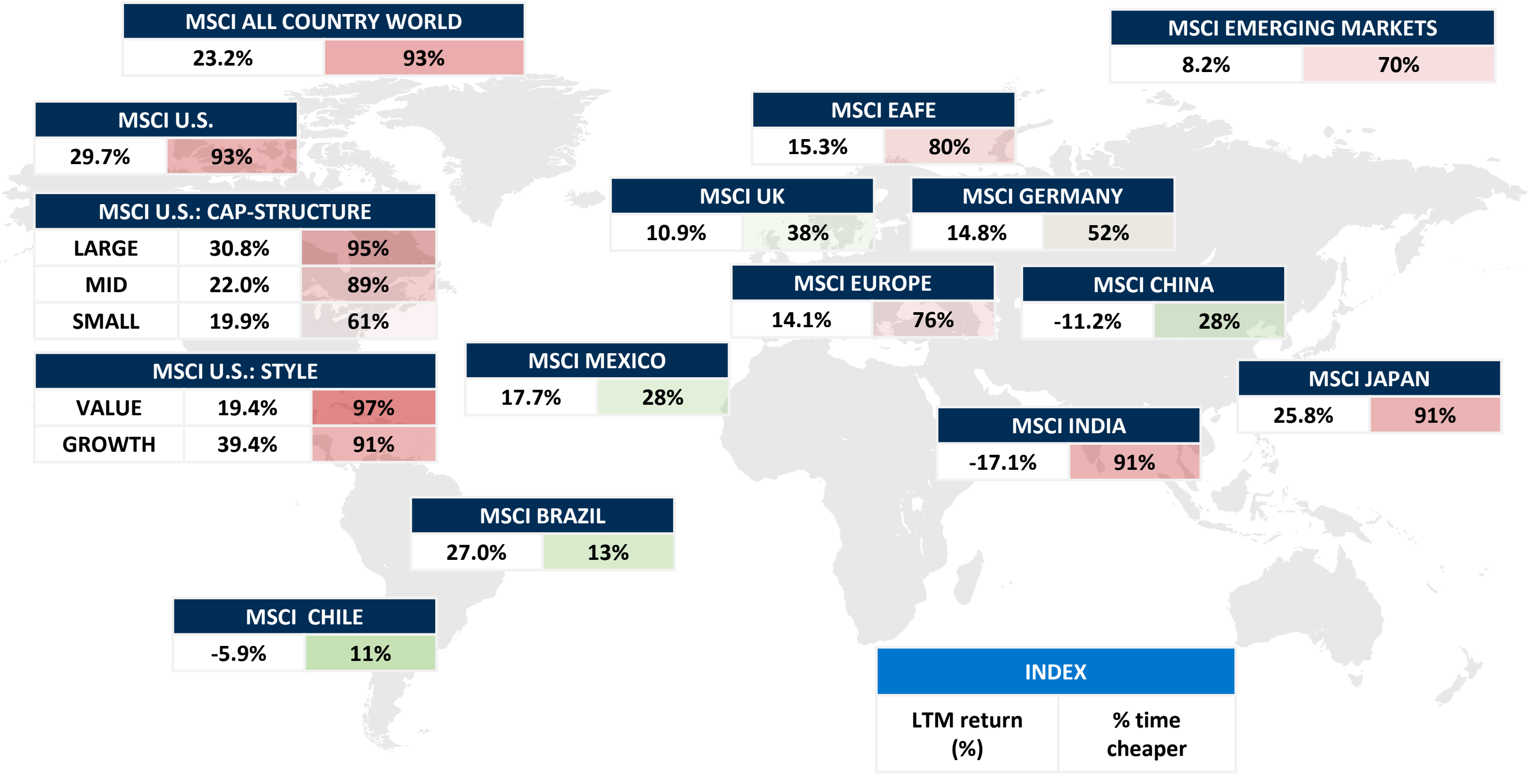
In the U.S., with the Magnificent 7 recording another outstanding quarter, large-cap equity valuations are the most stretched, while small- and mid-cap valuations remain relatively attractive. As investors look to take advantage of the soft landing and rate cuts backdrop, the cyclical features of U.S. small-caps are likely to become increasingly appealing. In Europe, although Germany is meaningfully less stretched than the U.S. market, its lackluster economy implies a less inspiring outlook. Japan's valuations are now clearly flagging as expensive, but the return of inflation, positive interest rates, and corporate governance reforms present opportunities for unlocking value.

Emerging market valuations are varied, with India being very stretched but others still being cheap. China's market will continue to struggling unless policymakers introduce new and impactful stimulus measures. In Latin America attractive valuations and positive fundamentals are colliding to make a very strong investment case.

Although global valuations are stretched, there are pockets of opportunity that can benefit from the constructive macro backdrop, including Latin America.

Global equity returns and valuations

Last twelve months returns and % times cheaper, MSCI indices



Source: FactSet, Bloomberg, MSCI, Principal Asset Allocation. LTM (last twelve months) returns are total return and in USD terms. % Time Cheaper is relative to PAA Equity Composite Valuation history. PAA Equity Composite Valuation is a calculated measure, comprised of 60% price-to-earnings, 20% price-to-book and 20% to dividend yield. Composite started in 2003. EAFE is Europe, Australasia, Far East. See disclosures for index descriptions. Data as of March 31, 2024.

Fixed income: We're here for the carry

The combination of solid economic growth and a Federal Reserve that is clearly keen to cut policy rates has solidified a constructive backdrop for credit. Higher yields and lower interest rate volatility should continue to support strong institutional demand, while ETF inflows reflect healthy retail appetite.

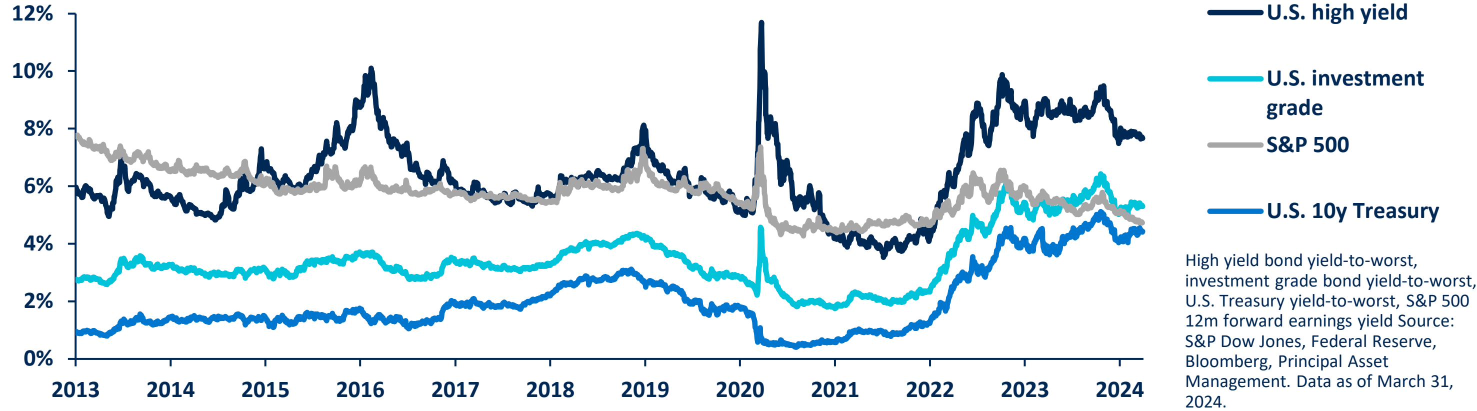
Spreads are historically tight for both investment grade and high yield credit. Yet, while spreads may not tighten significantly from here, provided the economy does not deteriorate significantly, they should not widen much either. More pertinently, credit is offering important additional carry to U.S. Treasurys, while the total yield available in fixed income is also attractive compared to equities.

A much-flagged risk for high yield this year is that due to the Fed's 2022-23 hiking cycle, the wall of maturing debt will face significantly higher refinancing costs, potentially triggering a spike in defaults. However, the resilient macro backdrop and strong balance sheets suggest that companies should scale the wall relatively unscathed. In addition, the maturity wall leans towards high-quality, suggesting that most companies will be able to digest the interest rate costs without too much strain.

Although credit spreads remain tight, fixed income today offers important carry opportunities. Concerns around the high yield maturity wall are likely overblown.

Yield comparison: High yield bonds, investment grade bonds, U.S. Treasurys, and S&P 500

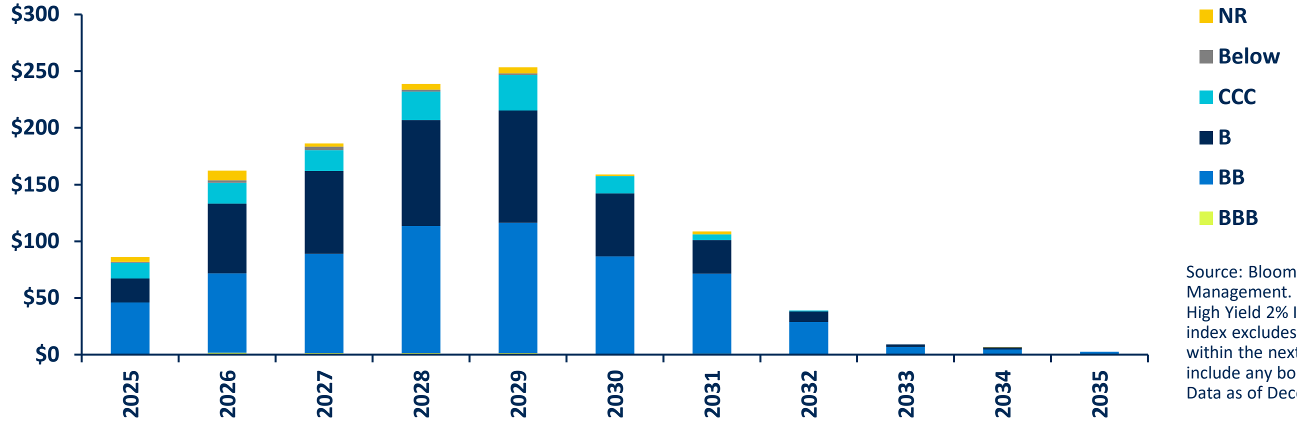
2013–present



High yield bond yield-to-worst, investment grade bond yield-to-worst, U.S. Treasury yield-to-worst, S&P 500 12m forward earnings yield Source: S&P Dow Jones, Federal Reserve, Bloomberg, Principal Asset Management. Data as of March 31, 2024.

High yield bond maturity schedule

Billions USD



Source: Bloomberg, Principal Asset Management. Data represents the U.S. High Yield 2% Issuer Cap index. As this index excludes bonds that mature within the next year, the chart does not include any bonds maturing in 2024. Data as of December 31, 2023.

The wall of cash is looking for a new home

Assets in money market funds have ballooned to a record $6 trillion, with investors attracted by elevated yields and partially hiding from an uncertain U.S. economic outlook. Now, with rate cuts on the near-term horizon, this cash may represent a potential tailwind to risk assets.

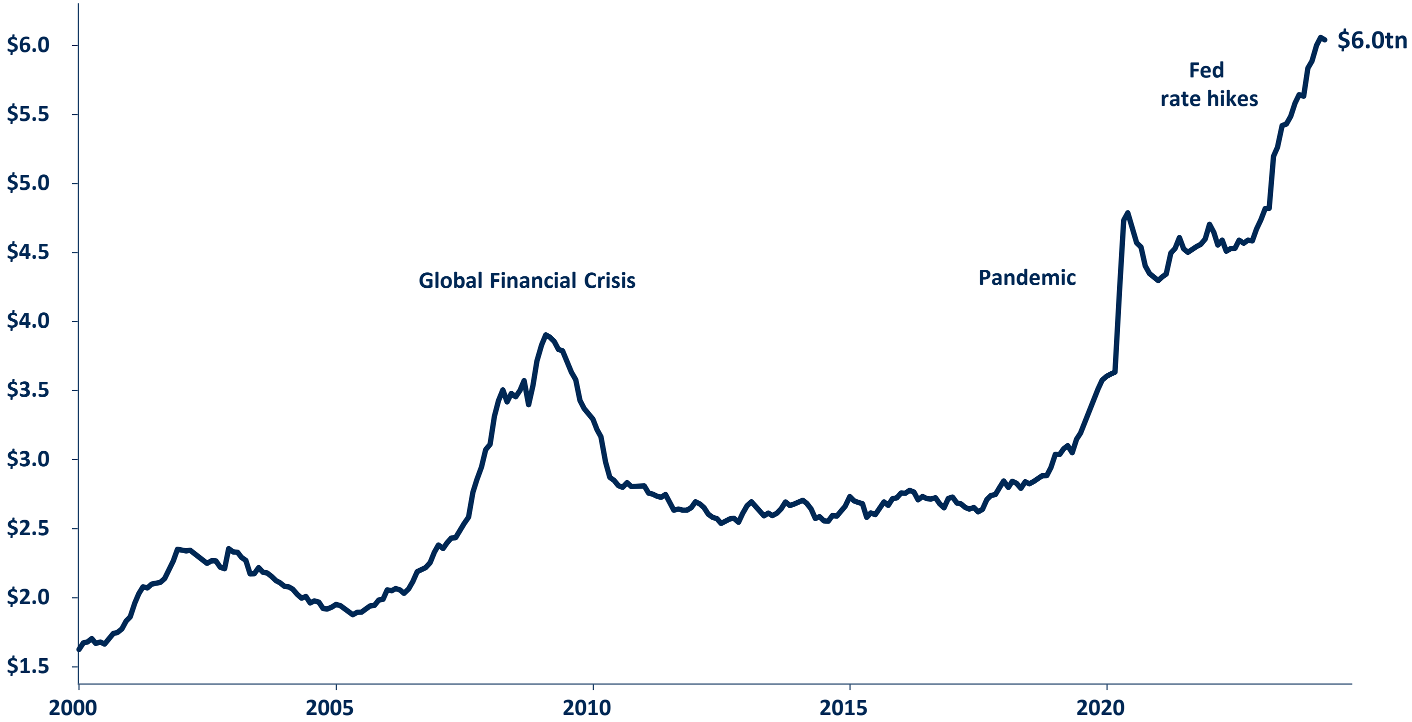
Many of the concerns and questions of recent years should finally be resolved over the coming months. The economy is slowing but is on course for a soft landing, earnings growth will likely remain positive, and the Fed is likely to cut rates later this year, reducing the attractiveness of cash.

Non-cash assets can deliver solid returns and provide important diversification in portfolios. In the base case scenario, a soft landing, risk assets like equities should outperform. If, however, this is too optimistic and recession materializes, bonds can offer stability and a hedge against the downside risks. If inflation resurges, alternatives such as real assets can outperform. With the potential for gains across the asset class spectrum, the main risk is staying in cash.

Investors should be prepared: Rate cuts should ignite a surge in sentiment—and there's a massive $6 trillion mountain of cash to fuel the resulting rally in risk assets.

Money market funds have surged in recent years but, in 2024, with rate cuts likely and the economy still on a positive path, risk assets should perform strongly, and cash is set to lose its attractiveness.

U.S. total money market fund assets
Trillions, 2000–present



Source: Clearnomics, Federal Reserve, Investment Company Institute, Bloomberg, Principal Asset Allocation. Data as of March 31, 2024.

Diversified asset allocation: Positioned for risk on

Asset allocation	Investment preference Less < <		Neutral		> > More
Equities			○ →	●	
Fixed income			○ →	●	
Alternatives		●	← ○		
Equities					
U.S.				●	
Large-cap				●	
Mid-cap			●		
Small-cap			○ →	●	
Ex-U.S.		●			
Europe		●			
UK		●			
Japan			●		
Developed Asia Pacific ex-Japan			●		
Emerging markets			●		

Viewpoints reflect a 12-month horizon.

○ → ● indicates a change in preference from the previous quarter (light blue) to the current quarter (darker blue).

Asset allocation	Investment preference Less < <		Neutral		> > More
Fixed income					
U.S.			○ →	●	
Treasurys			●		
Mortgages			●		
Investment grade corporates				●	
High yield/Senior loans			○ →	●	
Preferreds (debt & equity)		○ →	●		
TIPS			●		
Ex-U.S.		●	← ○		
Developed market sovereigns			●		
Developed market credit			●		
Emerging market local currency				●	
Emerging market hard currency			●		
Alternatives					
Commodities			●		
Natural resources			●		
Infrastructure		●	← ○		
REITs			●	← ○	
Hedge funds				●	

Source: Principal Asset Allocation. Alternatives asset class include commodities, natural resources, infrastructure, REITs, and hedge funds. Allocations across the investment outlook can be proportionately adjusted so magnitudes across categories do not have to net to neutral.
Data as of March 31, 2024

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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