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3Q 2024

Global Market Perspectives

Losing some of the shine

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Key themes for 3Q 2024

- **There is U.S economic moderation, but cyclical upturns elsewhere.**
  U.S. growth is softening as lower-income households feel the bite of higher interest rates. Other developed markets are now enjoying cyclical upturns, yet the limited nature of their recoveries suggests that U.S. economic dominance still holds.

- **Global inflation tentatively resumes its last mile of deceleration.**
  The inflation scare of 1Q24 is now waning, but a few more months of soft inflation data are required to validate that disinflation is proceeding as necessary. Without a sharp labor market slowdown, global inflation will unlikely reach central bank targets until late 2025, if not 2026.

- **Central bank cutting cycles are set to be slow and shallow.**
  A first Fed rate cut could occur in September, provided inflation continues to decelerate and economic activity does not reaccelerate. Other central banks have started easing, but their next moves will fall back in line with the Fed's actions.

- **Equity markets can eke out positive gains, provided the economic backdrop remains solid.**
  That same economic strength that has delayed Fed cuts should support a positive backdrop for corporate earnings, ensuring that the set-up for U.S. equities remains reasonably constructive. Yet the concentration of gains does pose a risk.

- **Elevated fixed income yields continue drawing investor interest.**
  Macro resilience should ensure a gradual rise in defaults rather than a sudden spike, meaning credit spreads are unlikely to widen significantly from their current levels. Fixed income yields are markedly higher than a few years ago.

- **With potential gains across asset classes, staying in cash is the leading 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: Looking beyond the U.S.

Equities lost some momentum in 2Q as several risks confronted the global outlook, including inflation surprises, election shocks, and geopolitical risk. The S&P 500 hit a new record high, largely thanks to a 17% gain in the Magnificent 7. By contrast, the equal-weighted S&P 500 fell 2.6% in 2Q, Europe posted only marginal gains and Japan posted a loss.

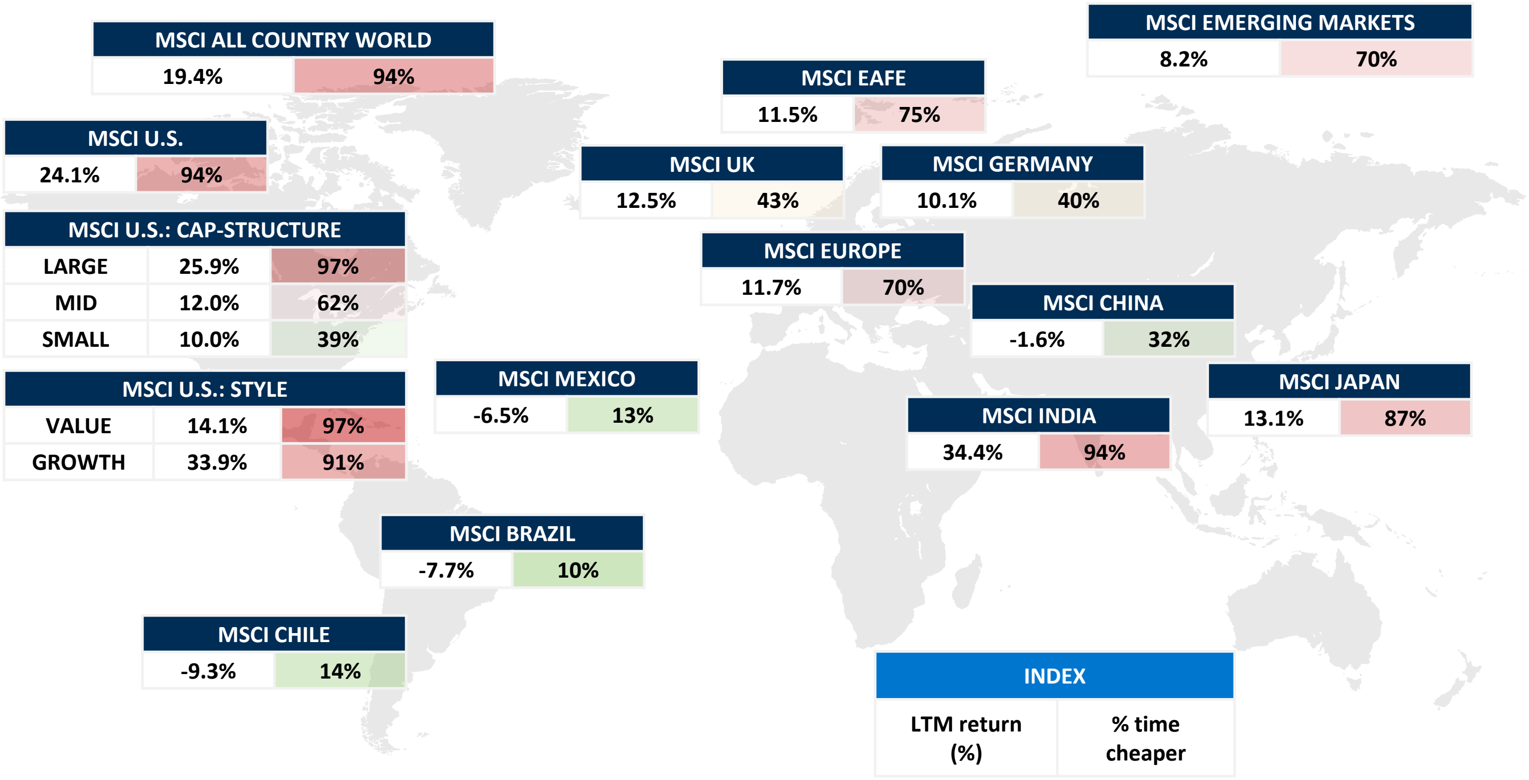
The U.S., along with India, are the most stretched markets. Large-cap U.S. stocks have rarely been more expensive, while small-caps are historically attractive. Yet, their relatively high share of floating rate debt implies that small-caps cannot stage a sustained recovery unless rate cuts materialize promptly and economic growth strengthens. In Europe, Germany remains meaningfully less stretched than the U.S. market and is enjoying a cyclical upturn. Yet, exposure to political risk and limited potential for a meaningful growth upgrade suggests that further gains could be lackluster. Japan's valuations are clearly flagging as expensive, but momentum in corporate governance reforms presents opportunities for unlocking value.

Segments of the Latin America and Asia EM complex are historically cheap and have strong fundamentals. However, China continues to be pressured by its weak macro outlook.

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 June 30, 2024.

A soft landing should maintain tight spreads

Credit spreads for both investment grade and high yield are currently near historic lows and are unlikely to narrow further. Yet attractive yields are helping to offset unappealing credit spread entry points.

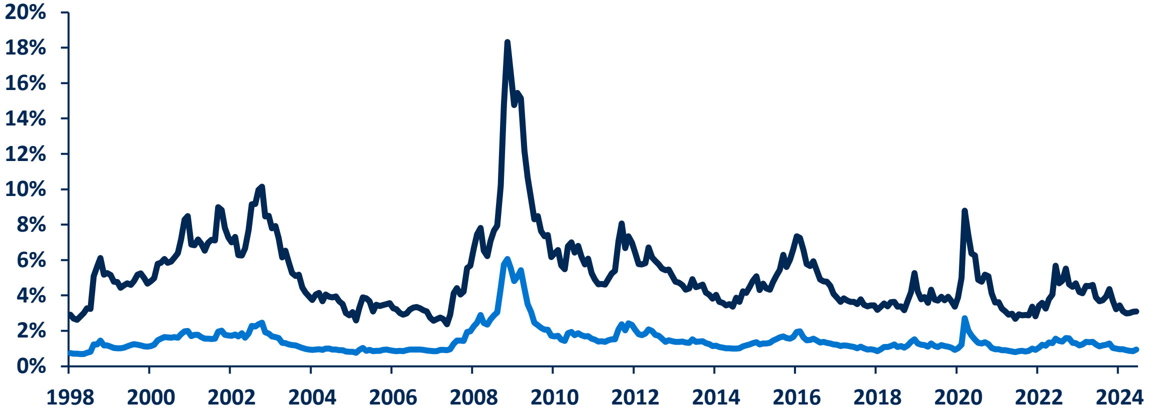
What's more, provided recession is avoided, a gradual rise in defaults is more probable than a sudden spike, meaning spreads are unlikely to widen significantly from their current levels. Additionally, it is noteworthy that despite recent macro volatility, spreads have remained within a relatively tight range. This suggests an attractive "stability" element to credit which should continue even amidst ongoing debates about interest rates.

In an environment of solid economic growth and higher for longer rates, the short duration and cyclical exposure of high yield is attractive. A much-flagged risk for high yield is that the wall of maturing debt will face significantly higher refinancing costs, potentially triggering a spike in defaults. However, the resilient, albeit slowing, macro backdrop and strong balance sheets suggest that companies should scale the wall relatively unscathed. In addition, the maturity wall leans towards high-quality, so 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.

U.S. high yield and investment grade spreads

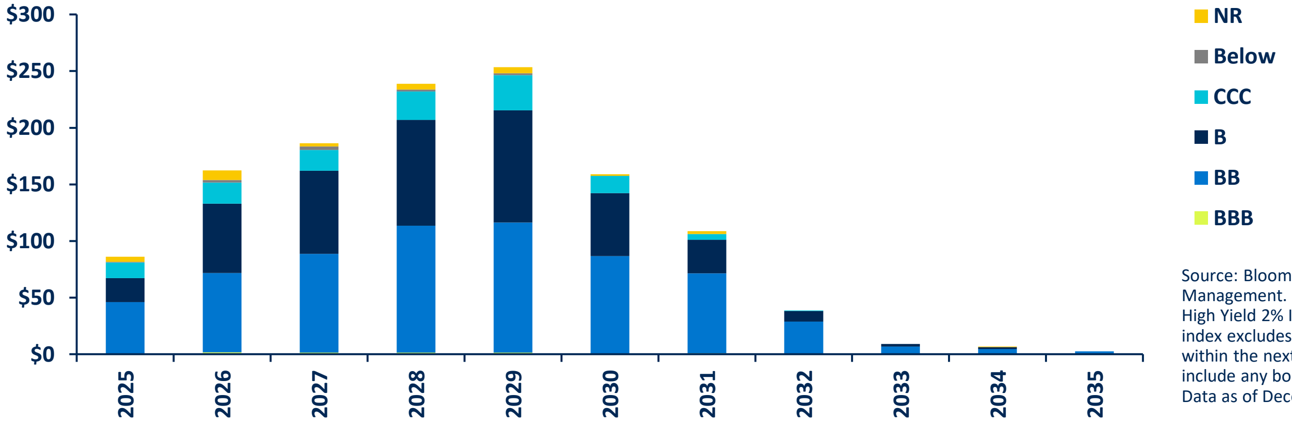
Option-adjusted-spread, 1998–present



Source: Bloomberg, Principal Asset Management. Data as of July 4, 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.

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 credit	○	○	●	← ◌	○
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 June 30, 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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INDEX DESCRIPTIONS

Bloomberg U.S. High-Yield Corporate Bond Index is a rules-based, market-value-weighted index engineered to measure publicly issued non-investment grade USD fixed-rate, taxable and corporate bonds.

Bloomberg U.S. Corp High Yield 2% Issuer Capped Index is an unmanaged index comprised of fixed rate, non-investment grade debt securities that are dollar denominated. The index limits the maximum exposure to any one issuer to 2%.

Bloomberg U.S. Corporate Investment Grade Index includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity and quality requirements. To qualify, bonds must be SEC-registered. The corporate sectors are industrial, utility and finance, which include both U.S. and non-U.S. corporations.

Bloomberg U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint. STRIPS are excluded from the index because their inclusion would result in double-counting.

MSCI ACWI Index includes large and mid cap stocks across developed and emerging market countries.

MSCI Brazil Index is designed to measure the performance of the large and mid cap segments of the Brazilian market.

MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

MSCI EAFE Index is listed for foreign stock funds (EAFE refers to Europe, Australasia, and Far East). Widely accepted as a benchmark for international stock performance, the EAFE Index is an aggregate of 21 individual country indexes.

MSCI Emerging Markets Index consists of large and mid cap companies across 24 countries and represents 10% of the world market capitalization. The index covers approximately 85% of the free float-adjusted market capitalization in each country in each of the 24 countries.

MSCI Europe Index captures large and mid cap representation across 15 Developed Markets (DM) countries in Europe.

MSCI Europe Banks Index is composed of large and mid cap stocks across 15 Developed Markets countries in Europe. All securities in the index are classified in the Banks industry group (within the Financials sector) according to the Global Industry Classification Standard (GICS®).

MSCI Germany Index is designed to measure the performance of the large and mid cap segments of the German market.

MSCI India Index is designed to measure the performance of the large and mid cap segments of the Indian market.

MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market.

MSCI United Kingdom Index is designed to measure the performance of the large and mid cap segments of the UK market.

MSCI USA Growth Index captures large and mid cap securities exhibiting overall growth style characteristics in the U.S. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

MSCI USA Index is a market capitalization weighted index designed to measure the performance of equity securities in the top 85% by market capitalization of equity securities listed on stock exchanges in the United States.

MSCI USA Large Cap Index is designed to measure the performance of the large cap segments of the U.S. market.

MSCI USA Mid Cap Index is designed to measure the performance of the mid cap segments of the U.S. market.

MSCI USA Quality Index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage. The MSCI Quality Indexes complement existing MSCI Factor Indexes and can provide an effective diversification role in a portfolio of factor strategies.

MSCI USA Small Cap Index is designed to measure the performance of the small cap segment of the U.S. equity market.

MSCI USA Value Index captures large and mid cap U.S. securities exhibiting overall value style characteristics. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

Standard & Poor's 500 Index is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market.

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