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4Q 2024

Exclusiv

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Global Market Perspectives

Hard to be gloomy

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PRINCIPAL GLOBAL INSIGHTS TEAM

Seema Shah
Chief Global Strategist

Brian Skocypec, CIMA
Director, Global Insights & Content Strategy

Christian Floro, CFA, CMT
Market Strategist

Jordan Rosner
Sr. Insights Strategist

Ben Brandsgard
Insights Strategist

Key themes for 4Q 2024

- **A globally synchronized downturn produces a globally synchronized policy easing.**
  As global growth has weakened, policymakers have started to respond. The U.S. Federal Reserve is committed to avoiding recession, while China's recent policy measures also raise the odds of a global soft landing.
- **The U.S. economy: Slowdown does not imply recession.**
  Labor market cooling has triggered recession concerns, but the continued strength of consumer and corporate balance sheets implies that job layoffs, and therefore recession, can be avoided. A moderation to trend growth is likely.
- **Central banks are determined to secure soft landings.**
  The Fed is set to lower rates toward 3% and may frontload rate cuts if there are further signs of labor market weakness. The Fed's commitment to a soft landing will be mirrored by other central banks keen to avoid overly strong currencies.
- **Equity markets confront valuation challenges, but Fed cuts should support continued gains.**
  Historically, a Fed cutting cycle without recession has resulted in a strong equity market performance. While stretched valuations suggest gains may be more limited this time, a broadening of gains beyond just tech presents opportunities.
- **Fixed income typically shines in a late cycle slowdown.**
  Fixed income spreads are tight, but elevated yields continue to draw investor interest. Combined with strong growth, Fed cuts should reduce default risk, extending the credit cycle.
- **With potential gains across asset classes, staying in cash is the leading risk.**
  With the Fed's rate cutting cycle now underway, the attractiveness of cash is rapidly diminishing. As global stimulus lifts prospects for risk assets across the globe, investors should be optimizing this constructive environment.

Global equity valuations increasingly in focus

After severe turmoil hit the market in mid-3Q, global policy stimulus announcements pushed U.S. equities to new record highs, and Chinese equities recovered all their losses for the year within September alone. Japan was one of the few markets to record negative returns in 3Q, as yen appreciation took its toll.

The U.S. and India remain the most stretched markets. Large-cap U.S. stocks have rarely been more expensive, while a series of strong gains for small-caps have reduced their attractiveness over the quarter (albeit still meaningfully cheaper than large caps).

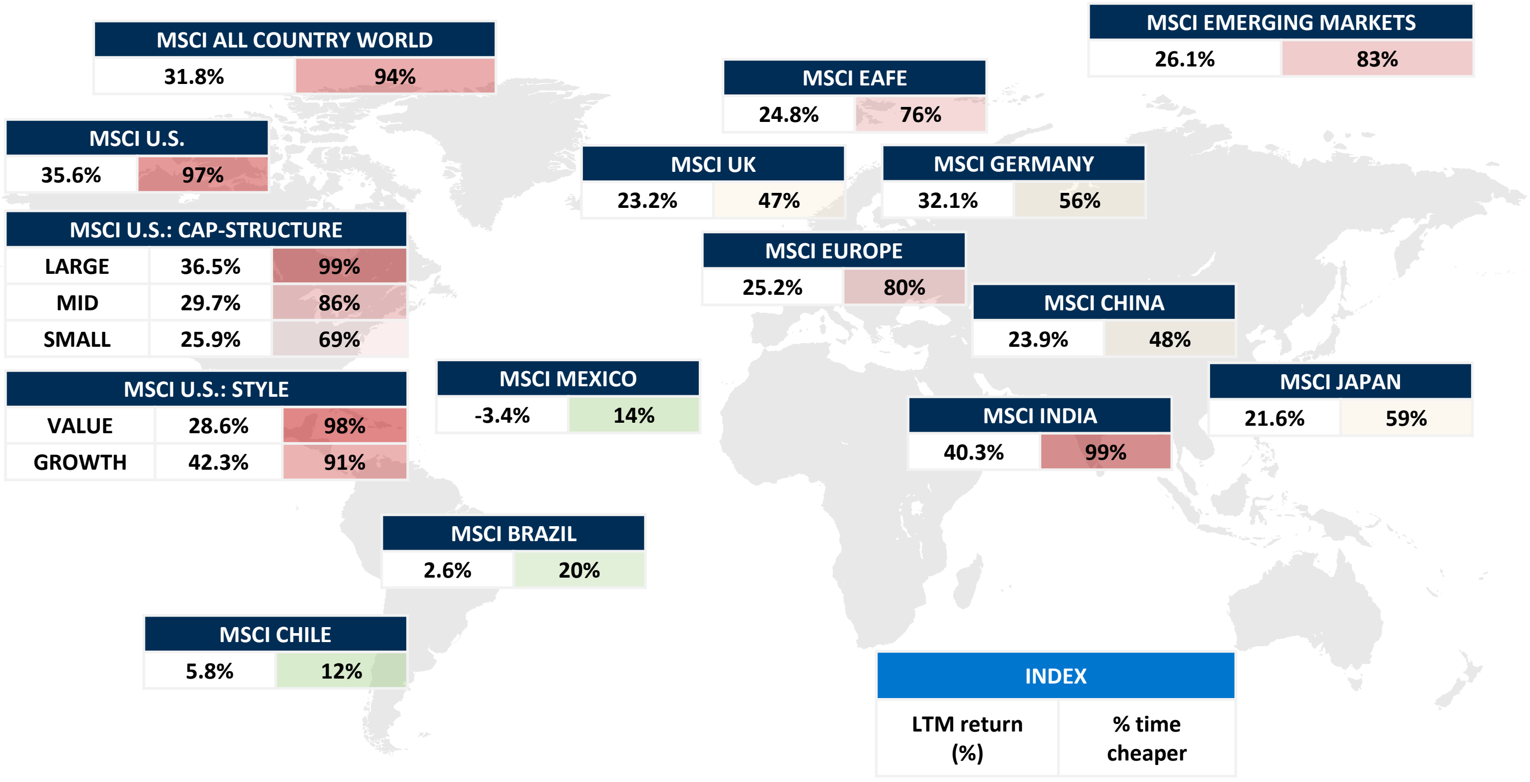
Although Germany and the UK remain meaningfully less expensive than the U.S. market, their valuations have become more stretched and are now in line with historical averages. With its stagnant economic backdrop, further gains for Germany could be limited. By contrast, Japan's valuations have seen a noticeable correction over the quarter and, with continuing momentum in corporate governance reforms, are likely to attract investor flows.

China's valuations are still historically cheap. If stimulus measures prove to be meaningful and are effectively implemented, recent significant gains could be extended.

Global stimulus measures should drive gains, particularly in markets where valuations are historically attractive. Increasingly, investors should consider global diversification.

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 September 30, 2024.

Realization of a soft landing could provide a lift to yields

The third quarter of 2024 saw an acceleration in expectations of global central bank policy easing amid growth concerns. As a result, sovereign yields declined through the quarter, with 10-year U.S. Treasury yields ending around 60bps lower than where they began.

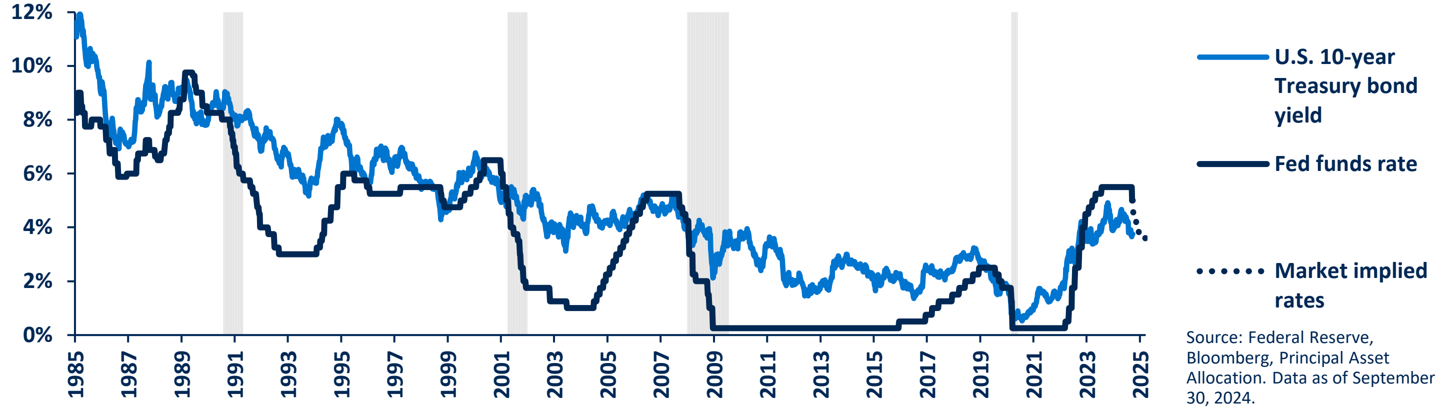
With the Fed's cutting cycle finally underway, history suggests there may be some additional downward pressure on U.S. Treasury yields. Yet, with significant Fed easing already priced into forward rates, the front end of the yield curve may already be close to its floor. A steepening of the yield curve is likely as the long-end should drift modestly higher as preemptive Fed easing engineers a soft landing. U.S. election-related volatility, plus market focus on fiscal sustainability as 2025 tax cut extension negotiations come into view, also likely limits the downside for bond yields. Keeping a slight duration overweight would be a valid hedge in case growth ultimately disappoints.

Overall, fixed income has continued to deliver positive performance in 2024, as macro conditions remain largely solid. The total yield generated from fixed income today remains attractive relative to history, and credit continues to offer additional carry to U.S. Treasurys.

While history suggests Fed cuts should push yields lower, the improvement in economic outlook suggests some mild upward drift in long-end yields, resulting in a steeper yield curve.

Fed funds rate and U.S. 10y Treasury bond yield

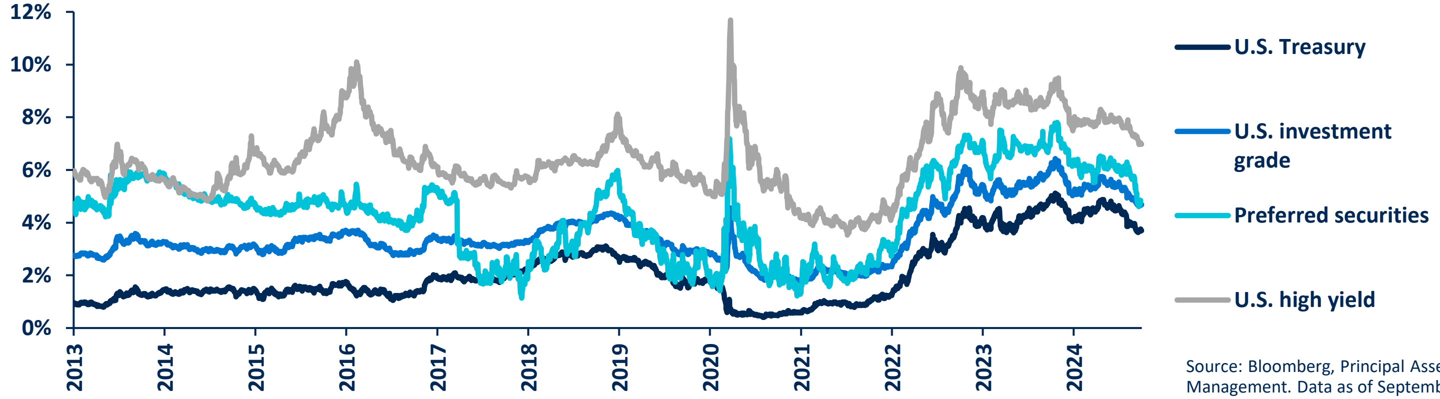
Recessions are shaded, 1985–present



Source: Federal Reserve, Bloomberg, Principal Asset Allocation. Data as of September 30, 2024.

Yield comparison

Yield-to-worst, 2013–present



Source: Bloomberg, Principal Asset Management. Data as of September 30, 2024.

Cash is not optimal in a rate cutting environment

With the Fed's monetary easing cycle now underway and rate cuts potentially front-loaded, the attractiveness of cash has declined. Some $6.4 trillion is currently sitting in money market funds, potentially representing an important tailwind for risk assets.

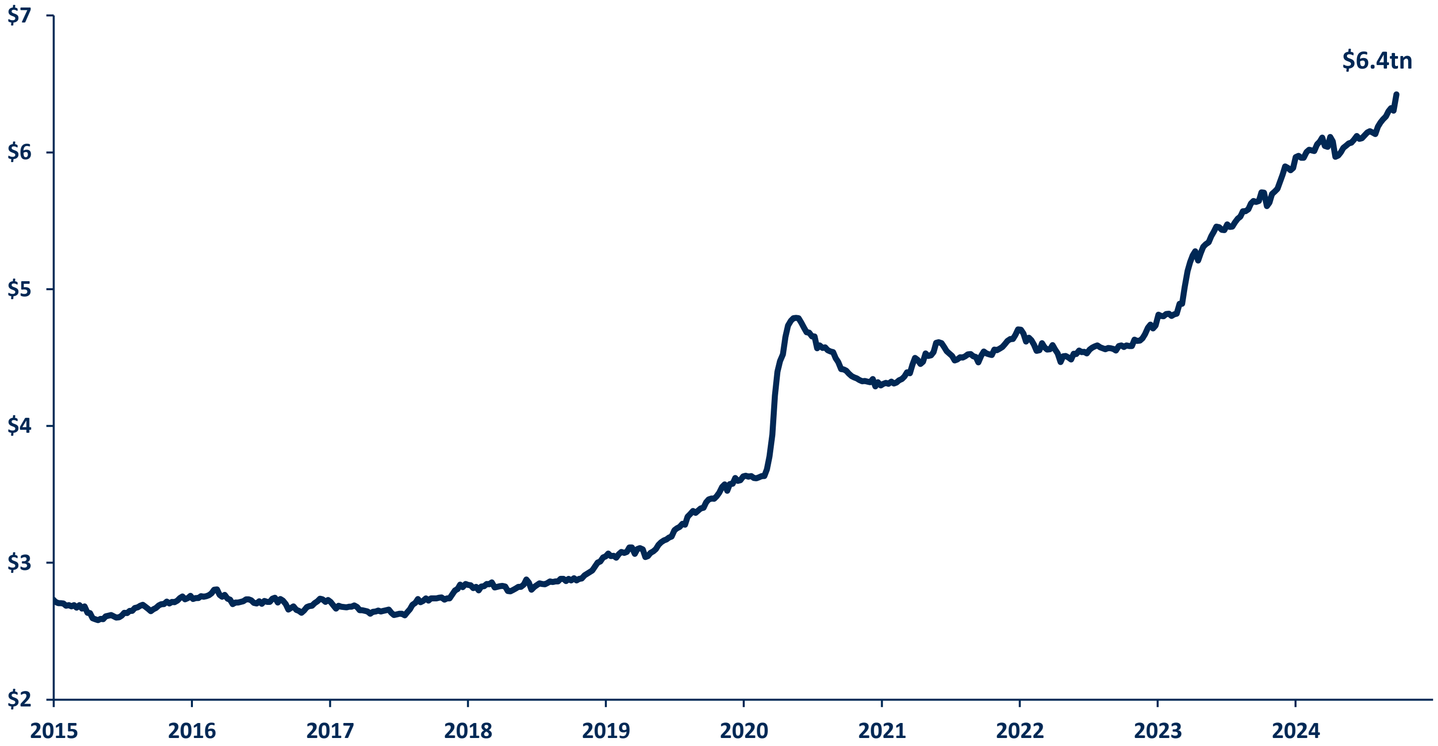
Putting a number on the potential flow into risk assets is difficult. In recent years, some of the increases in money market funds have simply been a conversion of demand deposits such as checking accounts and savings, which investors will likely maintain in liquid, safe assets. Yet, with risk assets facing a fairly positive outlook, there will inevitably be some flows into equities and credit.

Equities not only offer exposure to important secular themes, such as AI and technology, but in a rate-cutting, soft-landing environment, there is strong potential for positive returns. Similarly, high yield credits should also benefit from a rotation out of money market funds as investors look to higher-yielding assets. In addition, core fixed income can offer income stability and a hedge against downside economic risk.

The final quarter of 2024 will likely be beset by U.S. election volatility. Investors will need to keep cool heads, focus on the fundamentals, and resist the temptation to revert to cash.

Rate cuts are reducing the attractiveness of cash. With global stimulus lifting prospects for risk assets across the globe, investors should be optimizing this constructive environment.

U.S. total money market fund assets
Trillions, 2015–present



Source: Investment Company Institute, Bloomberg, Principal Asset Allocation. Data as of September 30, 2024.

A cautiously risk-on environment for investors

Despite global economic and geopolitical risks, coordinated central bank easing offers a prime risk-on investing opportunity.

Equities *Diversify via global equities, tactically leveraging small-cap for more risk-on*

- Attractive international valuations suggest opportunities outside the U.S.
- Explore opportunities beyond the Mag 7, including tactical exposure to small- and mid-cap stocks.
- Falling rates and slowing growth have historically been constructive for equity markets.

Implementation

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

Fixed income *Increase exposure to high-quality credit and extend duration*

- Leverage core fixed income during a mild economic slowdown.
- Extend duration as a hedge against growth disappointment.
- Emerging market debt may offer total return potential during global central bank easing.
- High yield maintains a substantial carry advantage for income-seeking investors.

Implementation

- IG credit heavy core fixed income
- Flexible emerging market debt strategies
- Active high yield strategies
- Preferred & capital securities

Alternatives *Pursue less correlated real asset exposures*

- Real return-focused strategies gain attractiveness when nominal growth slows.
- Infrastructure offers resiliency and attractive valuations.
- REITs offer attractive valuations and constructive fundamentals as rates move lower.

Implementation

- 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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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.

U.S. dollar index (USDX) is a measure of the value of the U.S. dollar relative to a basket of foreign currencies.

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