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2Q 2025

Exclusiv

البنك الأهلي المتحد

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Global Market Perspectives

The world turned upside down

Principal®

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Key themes for 2Q 2025

- **The global economy confronts upheaval as the U.S. looks to restructure international trade.**
  U.S. import tariffs have weakened the U.S. economy, while global economies sought to shore up their foundations to withstand the crosscurrents. Uncertainty is extraordinarily elevated and unlikely to clear immediately.
- **U.S. recession odds have spiked. Growth boosting policy measures are required to avoid recession.**
  The economy is being hit from multiple directions as consumers and businesses confront rising price pressures from import tariffs and labor market cracks. Deregulation and tax cuts will have to play a crucial role to offset the sharp rise in effective tariff rates if the U.S. is to skirt recession.
- **The Federal Reserve is biased to easy policy, but inflation fears will constrain the number of cuts.**
  Once the Fed has policy clarity, it will be able to focus on labor market concerns and resume rate cutting. Yet, inflation fears imply a shallow cutting cycle, providing only a limited stimulus injection into the U.S. economy.
- **U.S. equity markets to remain particularly challenged in the face of recession fears and tech woes.**
  U.S. economic growth is imperative if other sectors are to offset tech weakness. For now, the risk-off mood is likely to persist. International has outperformed as governments strengthen their economic foundations.
- **Fixed income is helping to weather the economic slowdown and market pullback.**
  Treasury yields may remain below 4% as recession fears persist. Credit spreads have widened but high-quality credit is performing its traditional role as ballast in investment portfolios.
- **The uncertain backdrop is challenging but prompts some important investor considerations.**
  Flows to money market funds have increased as investors defend against pullbacks and uncertainty. Global and cross-asset diversification remain crucial for capturing opportunities.

A global growth shock materializes

After several years of solid growth, the global economy faces a new policy-driven shock. The meaningful and rapid escalation of restrictive trade policy early into the new U.S. administration represents one of the biggest challenges to the post-WWII order that saw the proliferation of global free trade and dominance of the U.S. dollar. The ensuing negative shock is further amplified by a sharp increase in uncertainty driven by frequent and rapidly shifting U.S. policy announcements, with the impact reverberating across the global economy.

With solid balance sheets, U.S. companies benefit from a strong starting point. While growth forecasts are being downgraded and recession fears are rising, the U.S. economy has significant buffers to withstand policy-driven shocks.

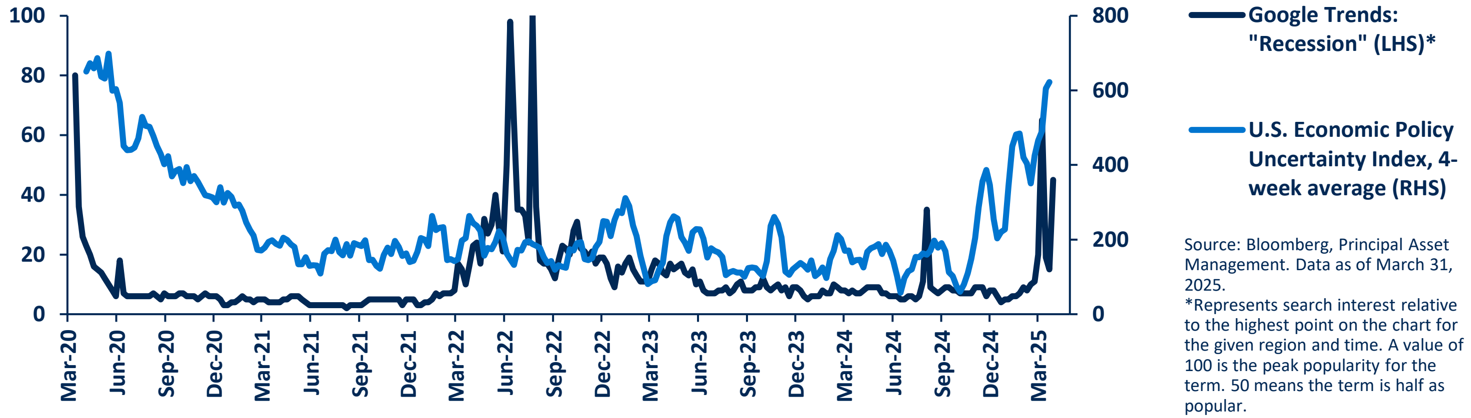
Europe and China are by no means immune to the negative global headwinds. Yet, with fiscal policymakers moving to offset growth risks, forcefully shifting away from fiscal conservatism in the case of German policymakers, economic concerns have begun to subside somewhat.

Whether Europe and China can deliver sufficiently in the face of the downside global growth risks may determine the lasting trend of U.S. exceptionalism.

The U.S. economy is facing a significant policy-driven shock. Forceful policy actions in Europe and China would reduce the risks to global growth.

U.S. recession trends

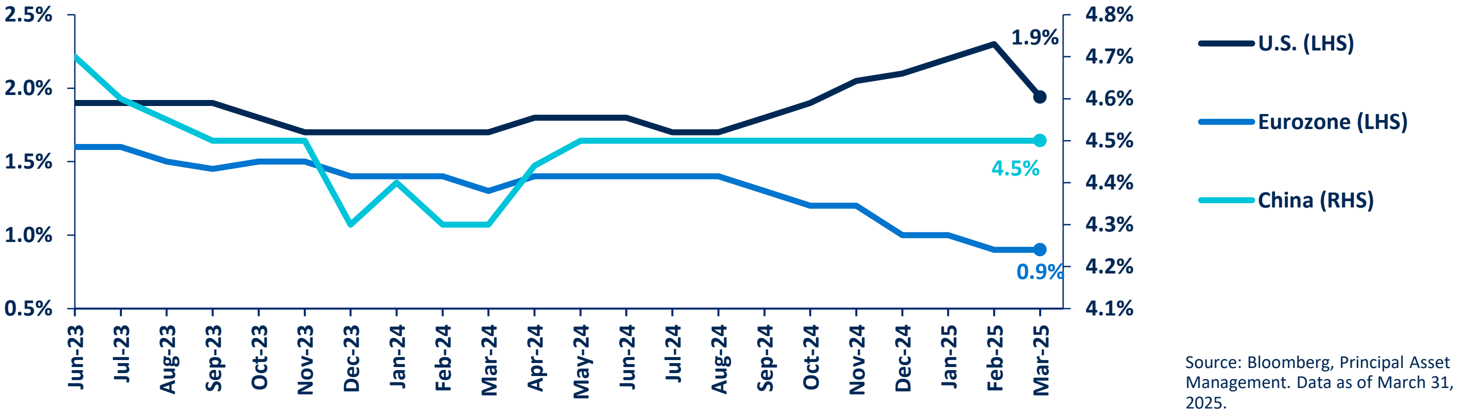
Google trends popularity level and Uncertainty Index level



Source: Bloomberg, Principal Asset Management. Data as of March 31, 2025.
*Represents search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term. 50 means the term is half as popular.

2025 GDP forecast

Consensus 2025 real GDP growth forecasts for U.S., Eurozone and China



Source: Bloomberg, Principal Asset Management. Data as of March 31, 2025.

Tariffs—potentially a U.S. own goal

So far this year, the U.S. economy has only faced headwinds and has not yet benefited from any tailwinds. Tariffs were enacted not only earlier than expected but are meaningfully larger than anticipated. The potential increase in the effective tariff from 3% to almost 25%, the highest level since 1908, is eight times the increase seen in President Trump's first term and five times larger than what had been widely expected.

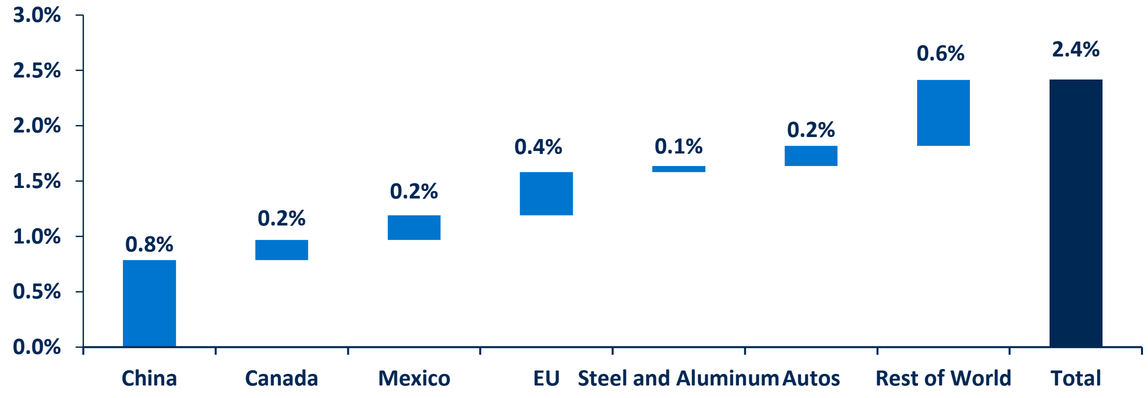
Our estimates suggest that the announced tariffs, to date, could lower U.S. growth by almost 2.5%, with the fallout potentially larger if some trade partners retaliate and it leads to an escalatory tariff cycle. Equally, negotiation could lower some of the higher individual tariff rates, reducing the economic impact.

If the expected $600-700 billion in annual tariff revenues are used to finance new fiscal stimulus in the form of additional corporate or income tax cuts, it would provide a crucial offset to the direct tariff impact.

It is worth noting that while the administration's stated goal of tariffs—reshoring manufacturing and boosting capex—is certainly possible, the reality is that the process will likely take years. In the meantime, the steep tariffs will be an immediate drag on the economy, with limited short-term benefits.

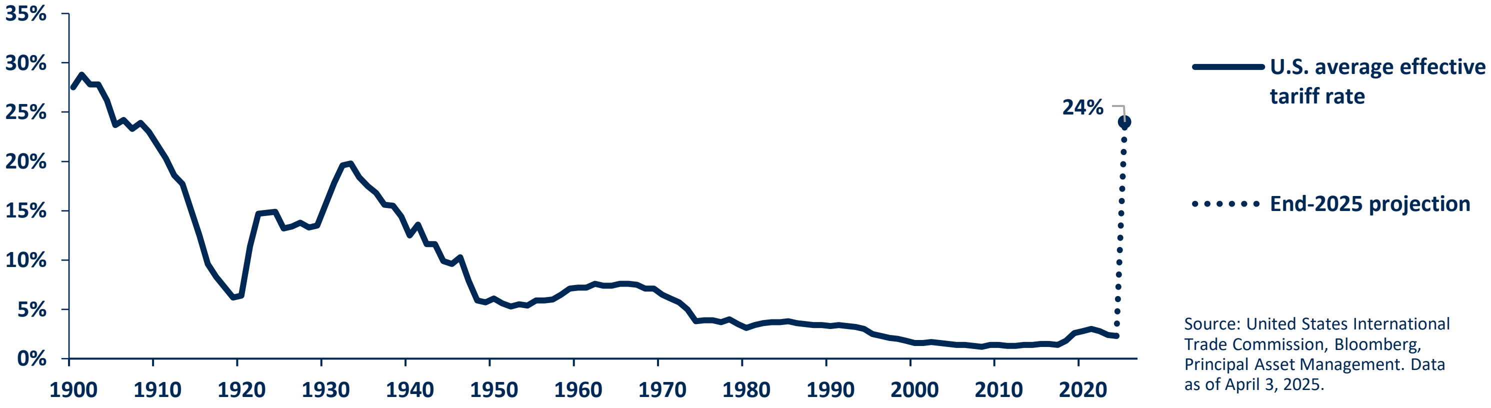
U.S. import tariffs, if maintained at current levels, are likely to lower GDP growth by 2.5%—raising the odds of recession.

Impact of tariff increases on U.S. GDP
Percentage



Source: International Monetary Fund, World Trade Organization, Census Bureau, Bloomberg, Principal Asset Management. Data as of April 3, 2025.

U.S. average effective tariff rate
1900–present



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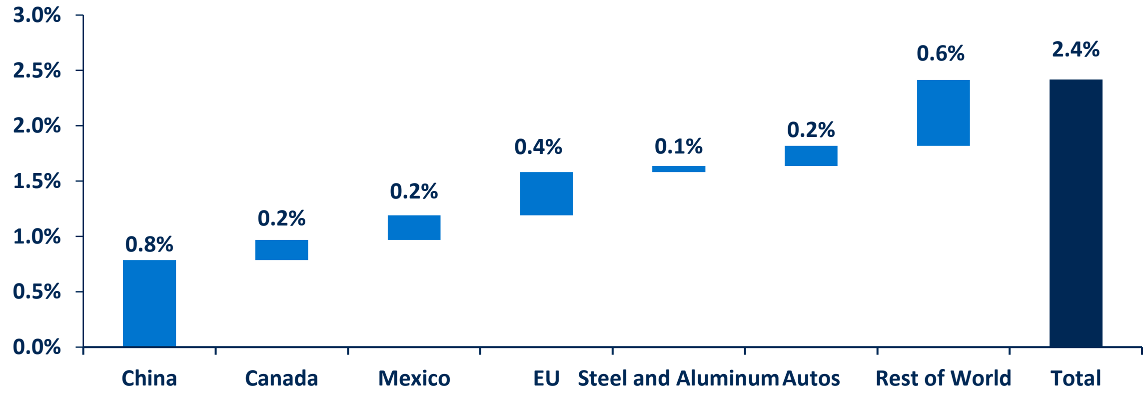

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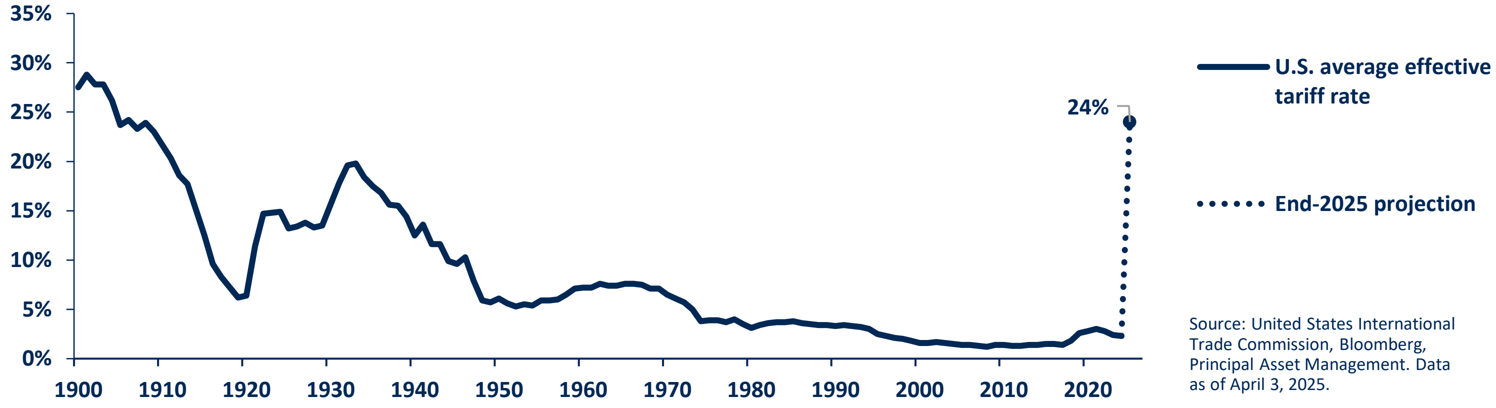


Source: United States International Trade Commission, Bloomberg, Principal Asset Management. Data as of April 3, 2025.

Global valuations: Investors finally take notice

Investors started the year looking to capitalize on valuation asymmetries. Attractive valuations in Europe and segments of emerging markets, including China, drew investor interest. However, by the end of 1Q, the valuation picture had adjusted somewhat.

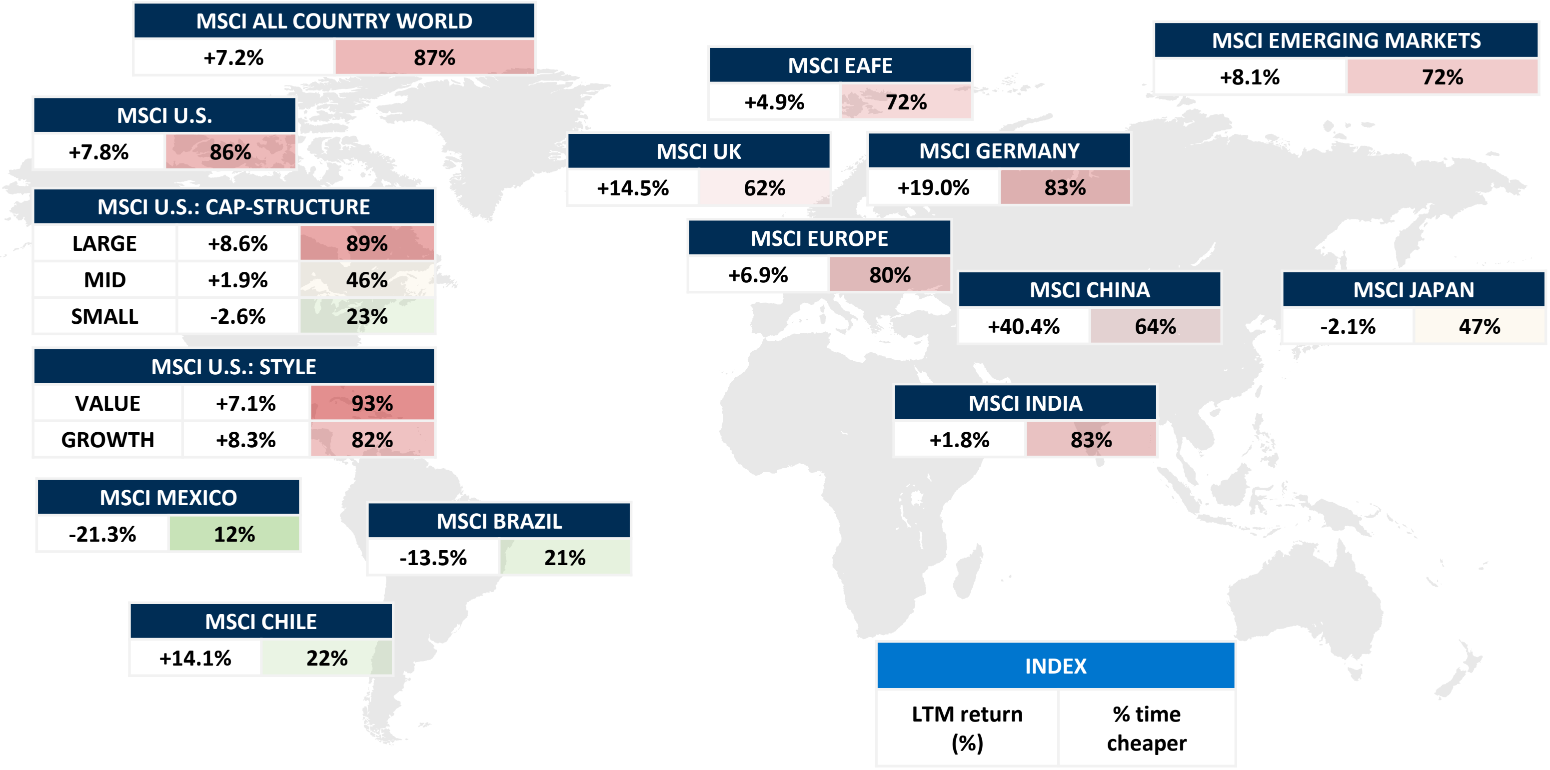
The U.S. remains historically expensive but less so than at the start of the year. Small caps look very attractive, but the growth backdrop implies that valuations may be insufficient to overcome weak fundamentals. By contrast, after a tremendous market rally, European valuation metrics now appear expensive compared to their history. MSCI Europe has traded at cheaper levels 80% of the time—not so different from the U.S. China still looks cheap relative to the broader market universe, but its strong Q1 performance means that its valuations have been cheaper 64% of the time. India's valuations are not as stretched as at the start of the year but remain historically expensive, while Japan looks historically cheap.

With the U.S. struggling with policy uncertainty and recession concerns and other economies such as China and Germany looking to strengthen their macro foundations, the focus on international markets has increasingly evolved into something more structural.

Valuation differentials have narrowed as global diversification proves its worth. The global opportunity set has broadened.

Global equity returns and valuations

Last twelve months returns and % of the time the Index been cheaper relative to its history since 2003, 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, 2025.

U.S. bonds caught in the growth/inflation crosshairs

Although bonds started the year with a sizeable selloff, pushing 10-year U.S. treasury yields above 4.8% in response to strong labor market data, government spending cuts, and tariff announcements prompted yields to rapidly reverse course in late January. Yields dropped to 4.3% by quarter-end, and then below 4% in early April as recession fears intensified.

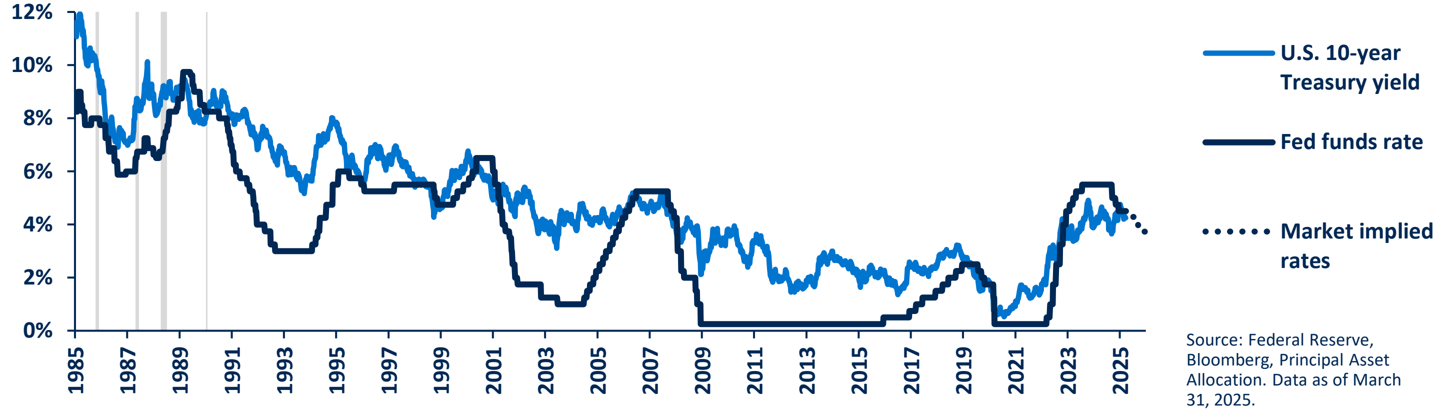
The contrasting outlooks for growth and inflation may complicate the outlook for yields from here. Most likely, growth concerns are likely to dominate sovereign bond dynamics, pushing yields lower as labor market cracks start to show more clearly. However, expected tariff-driven inflationary pressures imply that the bond rally may be somewhat capped.

In Europe, the significant fiscal shift in Germany drove 10-year Bund yields to post their biggest daily jump since German reunification in 1990, also pushing up sovereign yields across Europe. However, with short-term growth risks now biased to the downside as Europe begins to confront U.S. import tariffs – and provided other countries do not court fiscal controversy by expanding their spending — European sovereign yields are also on a downward path.

U.S. bond yields may trend lower as growth weakens, although rising inflation may cap the rally. European yields have likely hit their ceiling as tariff effects are realized.

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

Recessions are shaded, 1985–present



Source: Federal Reserve, Bloomberg, Principal Asset Allocation. Data as of March 31, 2025.

10-year Treasury yield and economic activity

November 2023–present

Source: Bloomberg, Principal Asset Management. Data as of March 31, 2025.

Investors' considerations to navigate this environment

The difficult market environment has driven even greater flows into money market funds. However, historically, and with few exceptions, investors experience several large market pullbacks each year. Volatility is a normal part of investing, and investors are often rewarded for staying disciplined through short-term volatility.

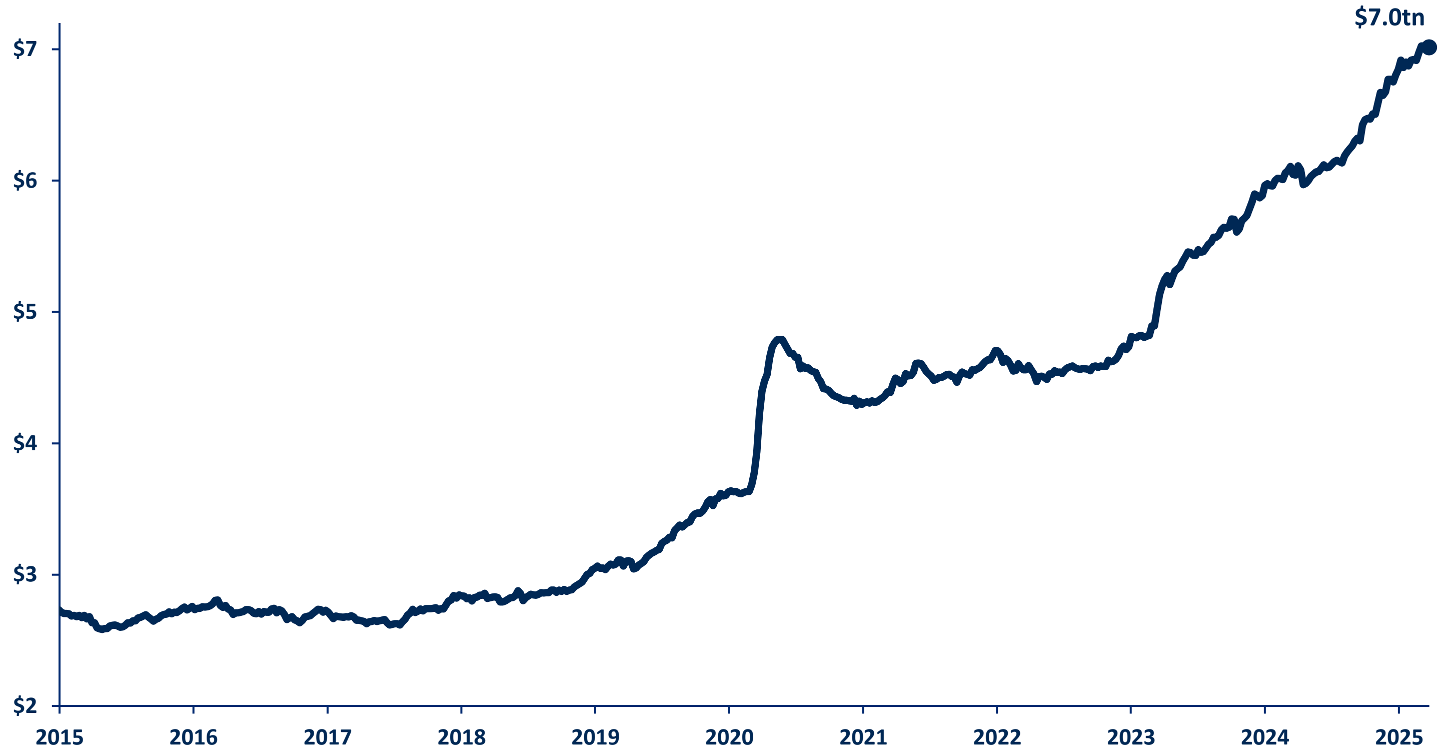
U.S. markets can still deliver decent equity returns as different types of companies perform well in differing macro environments. Active management can help identify potential outperformers in a weaker environment.

As the global economy adjusts to swift changes in U.S. policies, global diversification remains crucial for managing portfolio risk and capturing opportunities. With global policy stimulus increasingly in play to shore up economic resilience, coupled with the more attractive valuations, global markets can likely continue to deliver solid performance.

The benefits of cross-asset class diversification have been on full display, with fixed income performing its ballast role. REITs are outperforming their broader equity benchmarks, supported by defensive sector leadership and declining bond yields. In addition, liquidity will be key as an opportunity enabler for when a shift in market sentiment arrives.

Market pullbacks are not unusual. Equities only require modest growth environments; global diversification is crucial; cross-asset diversification benefits are currently on full display

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



Source: Investment Company Institute, Bloomberg, Principal Asset Management. Data as of March 31, 2025.

Defense and diversification in a disrupted cycle

With policy shocks roiling markets and global growth expectations, investors should pivot toward caution and quality

Equities *Lean into quality and global breadth as volatility rises*

- Emphasize fundamentally sound companies with strong free cash flows less prone to economic headwinds
- Explore opportunities beyond the Mag 7, including tactical exposure to small- and mid-cap stocks
- Narrowing valuation differentials suggest a broadening global opportunity set

Implementation

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

Fixed income *High-quality credit to serve as ballast amid widening spreads and weak sentiment*

- Increase allocation to investment-grade (IG) credit with strong balance sheets
- Extend duration selectively—attractive hedge in a slowing growth environment
- Maintain flexibility for potential spread compression entry points
- Consider deploying cash assets in higher-yielding income options, minimizing reinvestment risks

Implementation

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

Alternatives *Pursue less correlated exposures*

- Prioritize real return strategies in a stagflationary risk scenario
- REITs and infrastructure remain compelling amid falling yields and defensive rotation

Implementation

- Diversified real asset strategies (infrastructure, natural resources)
- Private real estate markets
- Proven REIT and GLI strategies
- Multi-strategy alternatives

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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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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