Principal Hong Kong
1Q 2025 Market Outlook

Key themes for 1Q 2025

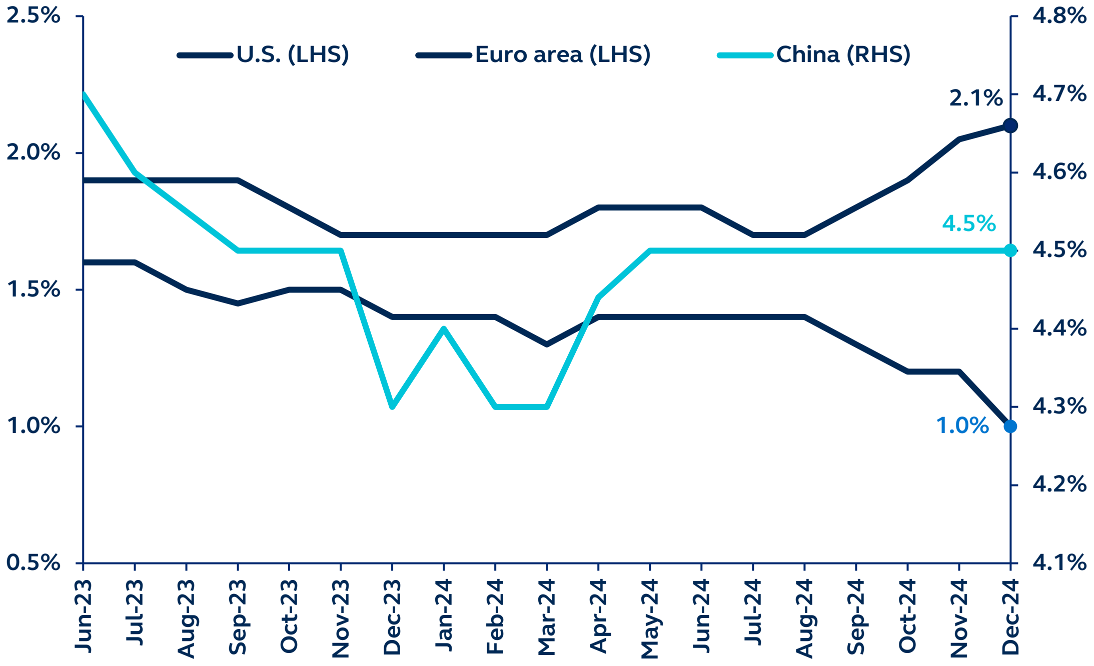
- **A complex global picture is emerging, with significant divergence in growth and policy actions.**
  While the U.S. continues to thrive, China and Europe are struggling. Proposed U.S. import tariffs threaten to intensify these diverging fortunes, reinforcing the U.S. exceptionalism theme. Policymakers will need to respond accordingly.
- **The U.S. economy remains resilient, but with pockets of weakness requiring careful watch.**
  Strong household and corporate balance sheets have created a very resilient economy. Nonetheless, low-income households and small businesses are struggling, highlighting the need for further interest rate relief to prevent weakness from spreading.
- **The Federal Reserve will likely adopt a slower, more cautious approach to policy.**
  Recent U.S. economic strength has combined with a rising threat of tariffs to increase upside inflation risks. The Fed is set to cut rates just a few times in 2025, likely hitting a floor of 3.75%. Interest rate relief will be shallow and restricted.
- **Equity market gains may be challenged by elevated bond yields and expensive valuations.**
  A strong economic backdrop will support continued solid earnings growth. Yet, expensive valuations imply elevated vulnerability to any earnings disappointment, while the recent rise in bond yields may exert pressure on gains.
- **Fixed income credit spreads to remain range bound, with a bias upwards.**
  The shallow Fed cutting cycle means that Treasury yields are unlikely to trend much lower. Credit spreads are near historic tights, but solid fundamentals and elevated starting yields imply credit could generate strong returns in 2025.
- **Flows into cash continue, but in this constructive environment, risk assets are more favorable.**
  While broad valuation concerns and policy uncertainty persist, the numerous pockets of value, coupled with inflation pressures and reinvestment risk, underscore the importance of investors optimizing opportunities in this favorable macro environment.

A complex global economic picture emerges

Diverging economic fortunes implies global policy desynchronization in 2025.

2025 GDP forecast

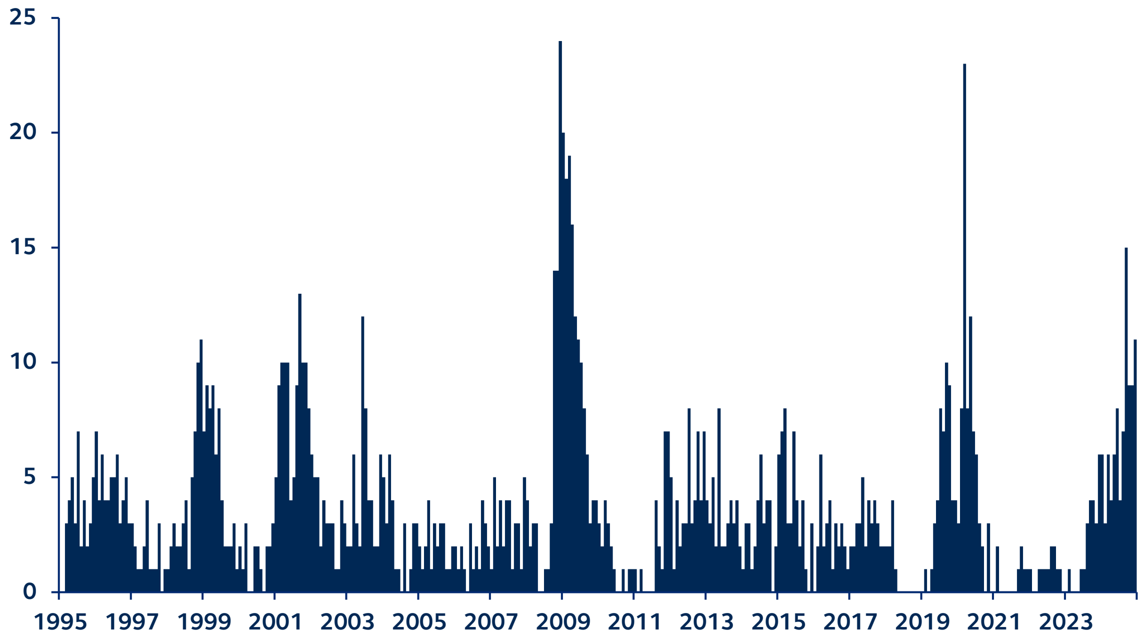
Consensus 2025 real GDP growth forecasts for U.S., Eurozone and China



Source: Bloomberg, Principal Asset Management. Data as of January 2, 2025

Global central bank easing

Number of central bank cuts, monthly, 1995–present



Source: Bloomberg, Principal Asset Management. Data as of January 2, 2025.

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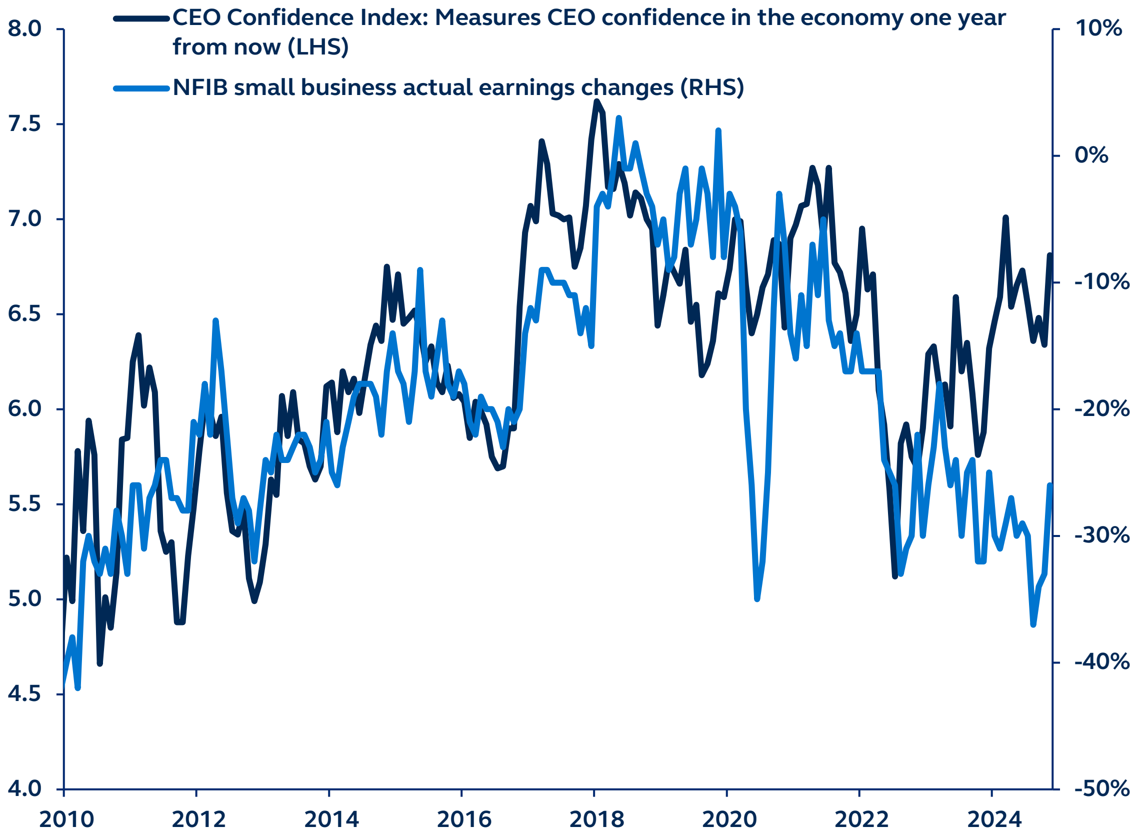
Slowdown concerns remain amid pockets of weakness

Low-income households and small businesses are struggling under high borrowing costs and elevated prices. Policymakers are rightfully concerned about these pockets of weakness.

Small and large business confidence

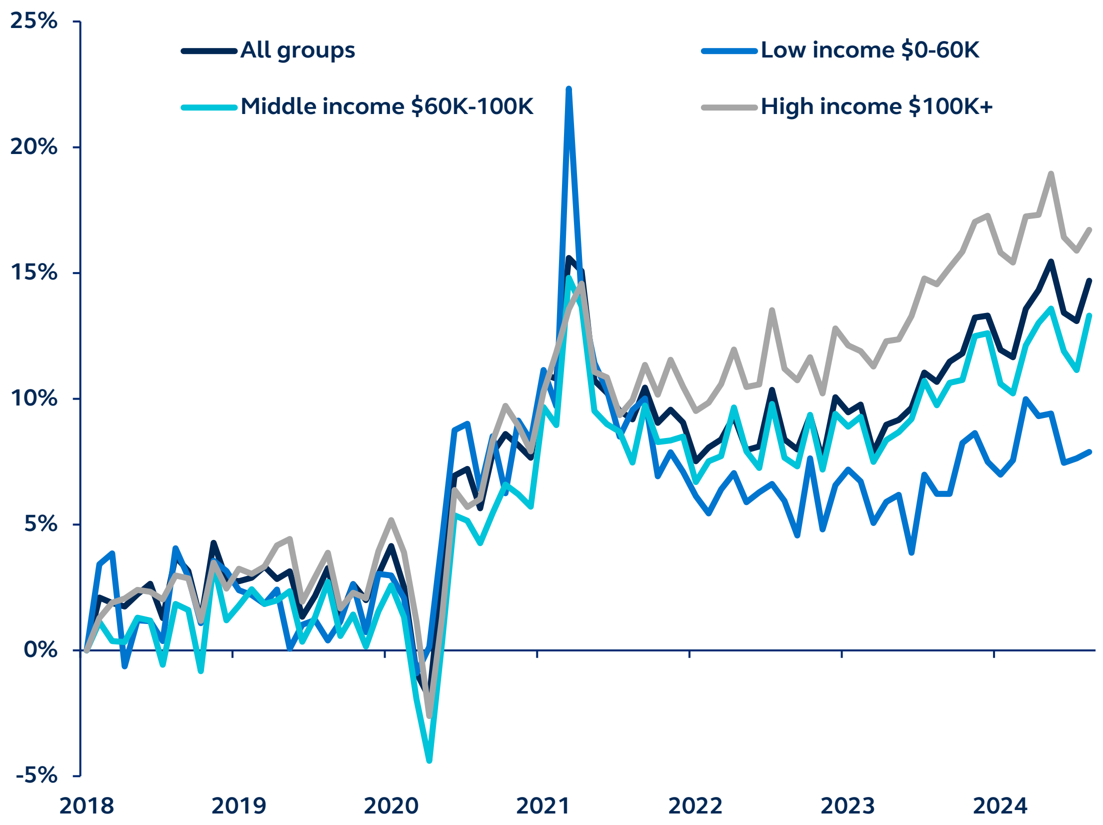
Level, January 2010–present



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

Growth of average retail spending

Seasonally-adjusted and inflation-adjusted, Rebased to 0 at January 2018



Source: Federal Reserve, Principal Asset Management. Data as of August 31, 2024.

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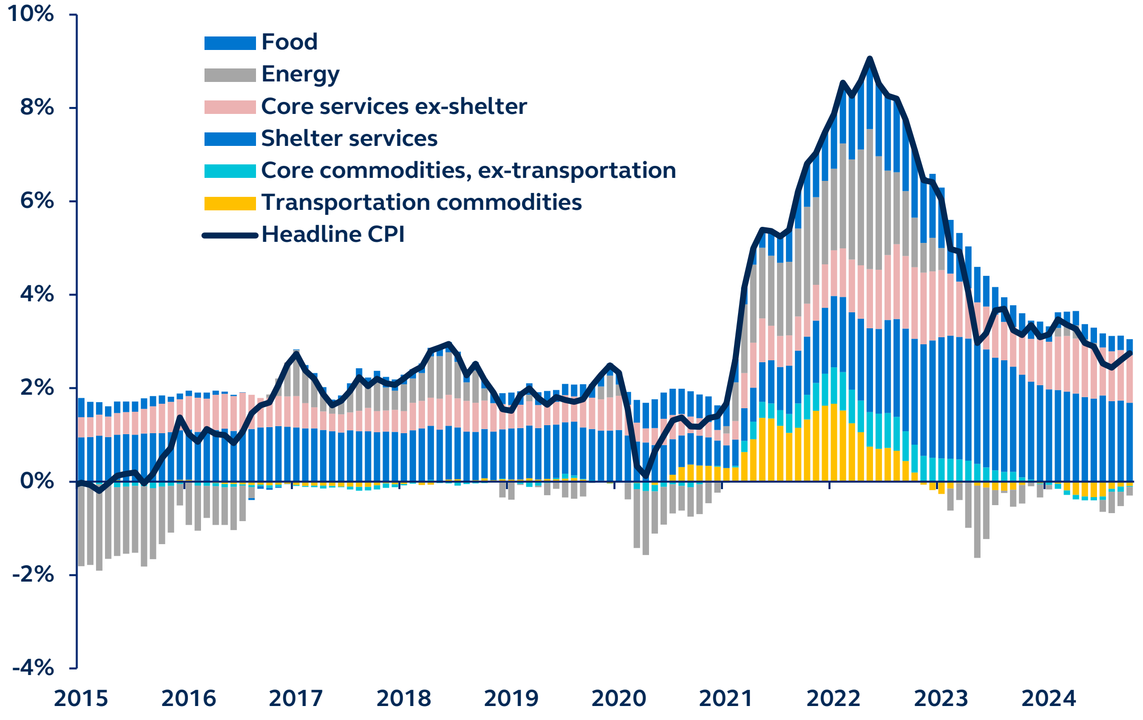
U.S. inflation: upside risks aplenty

Recent economic strength has combined with a rising threat of tariffs to increase upside inflation risks.

Contribution to headline U.S. inflation

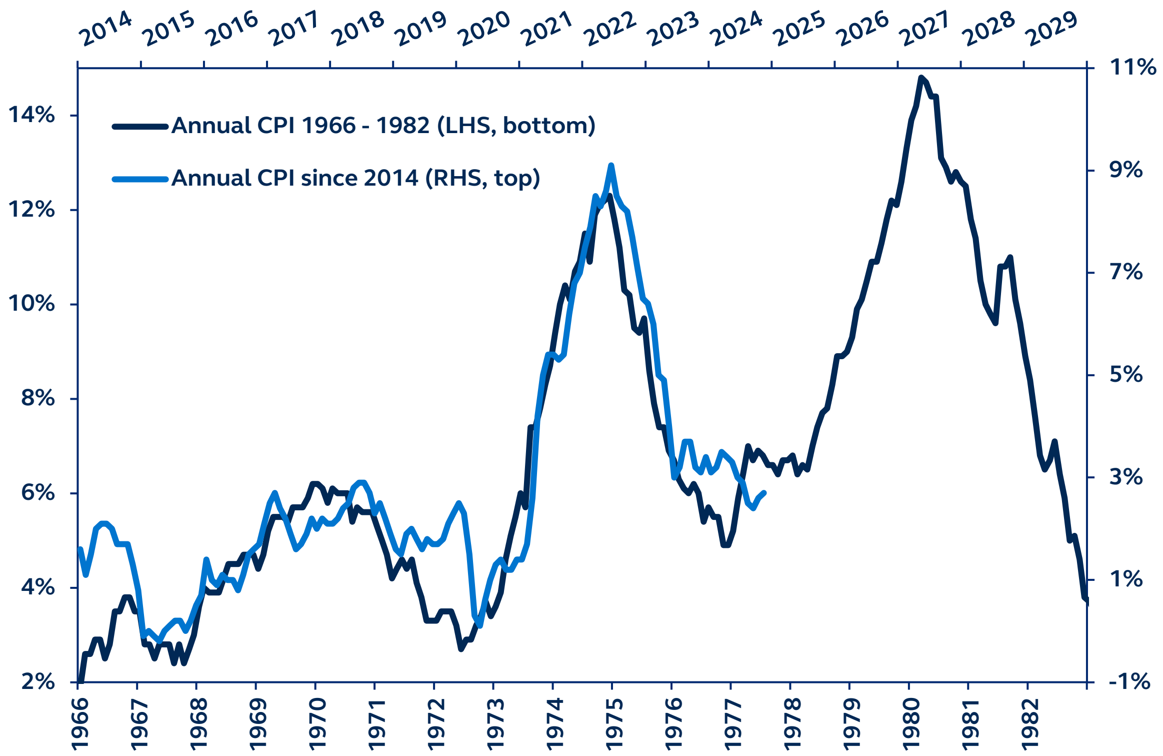
Year-over-year, January 2015–present



Source: Bureau of Labor Statistics, Principal Asset Management. Data as of December 11, 2024.

Historical inflation comparison

Consumer Price Index (CPI)



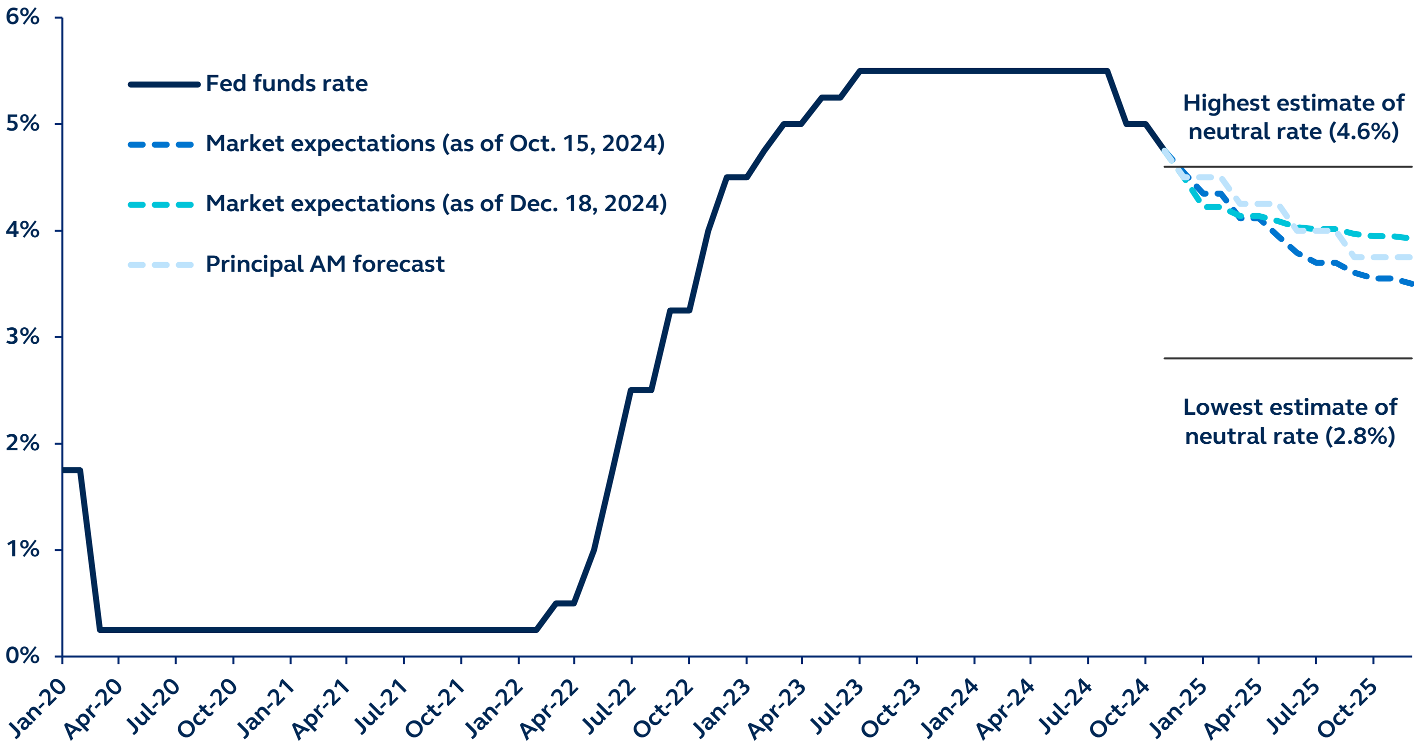
Source: Bureau of Labor Statistics, Bloomberg, Principal Asset Management. Data as of November 30, 2024.

Federal Reserve: Cautious on the face of uncertainty

The Fed is set to slow its easing path, cutting rates just a few times in 2025, hitting a likely floor of 3.75%. Interest rate relief will be shallow and restricted.

Federal Reserve policy rate path

Fed funds rate and projections, 2020–present



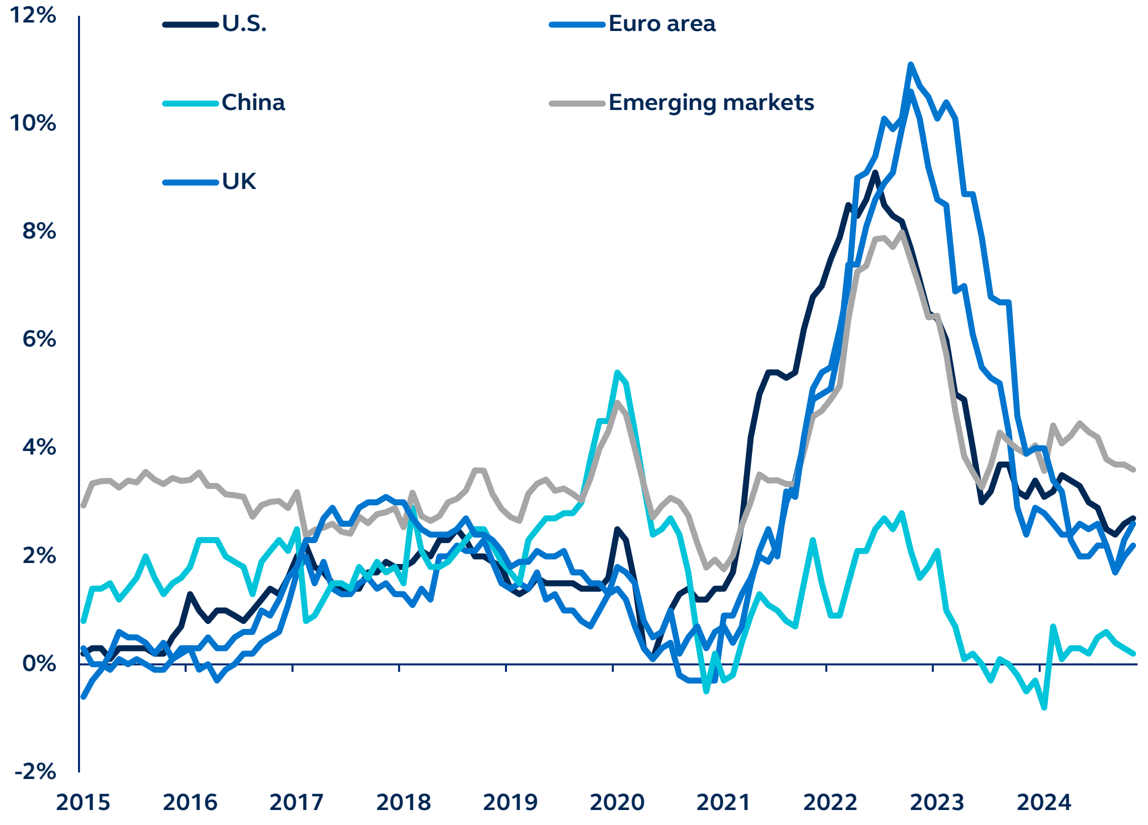
Source: Federal Reserve, Bloomberg, Principal Asset Management. Highest and lowest neutral rate estimate levels are derived from a wide range of Wall Street analysts and models. Data as December 18, 2024.

The global economy swaps inflation for growth concerns

While inflation is no longer such a headache for global central banks, they must now contend with downside growth risks—amplified by the threat of U.S. tariffs.

Global inflation

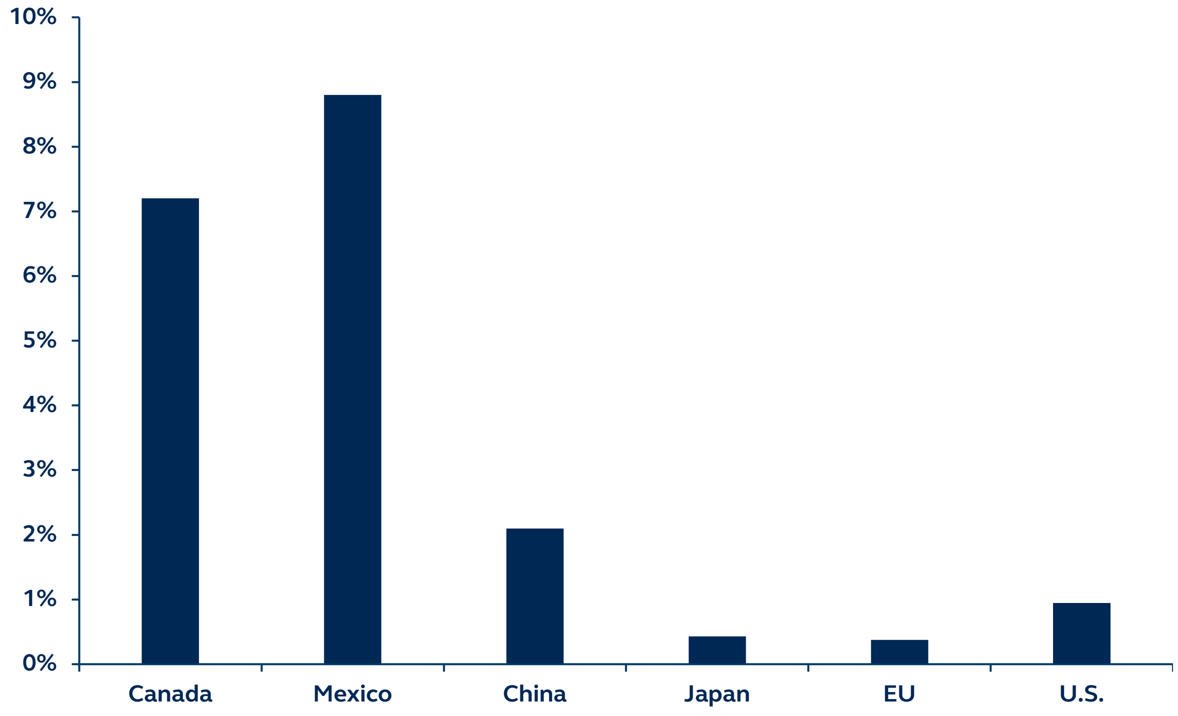
January 2015–present



Source: Bureau of Labor Statistics, Principal Asset Management. Data as of November 30, 2024.

Potential tariff increase impact on GDP

Percentage



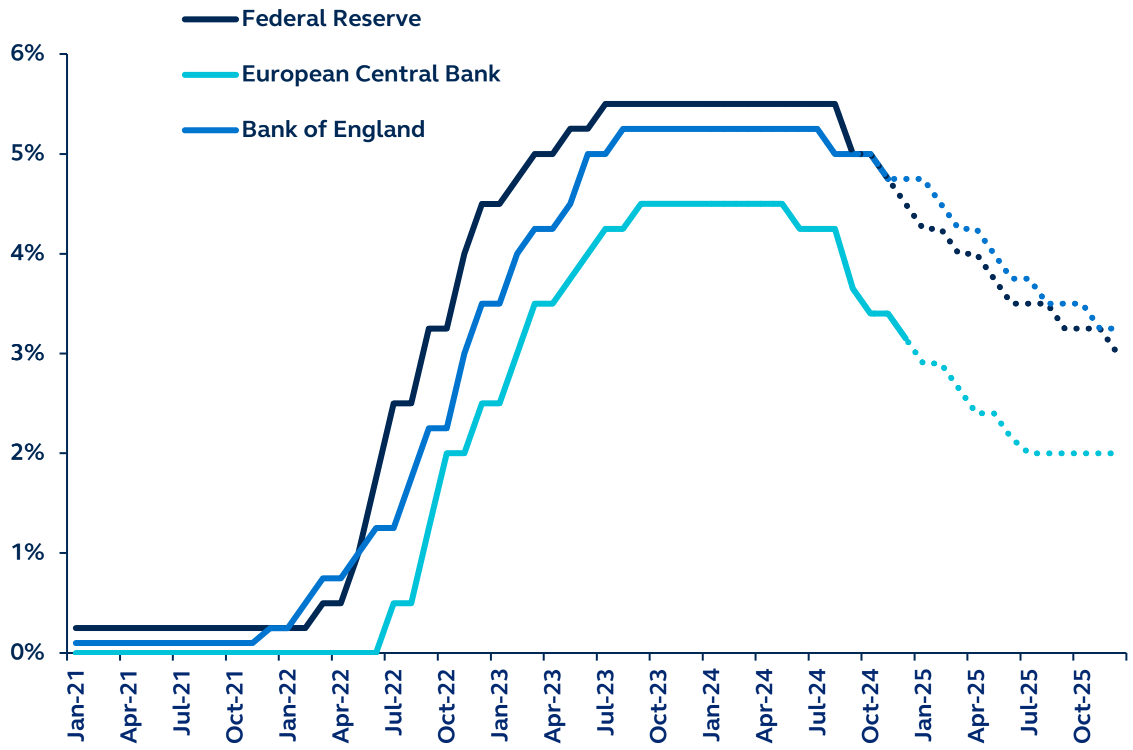
Source: International Monetary Fund, World Trade Organization, Bloomberg, Principal Asset Management. Data as of November 15, 2024.

The offset of global cross-currents is USD strength

Weaker growth outside the U.S. implies more aggressive rate cuts by global central banks. The policy mix of a relatively hawkish Fed and U.S. import tariff hikes will support sustained U.S. dollar strength.

Global central bank rates

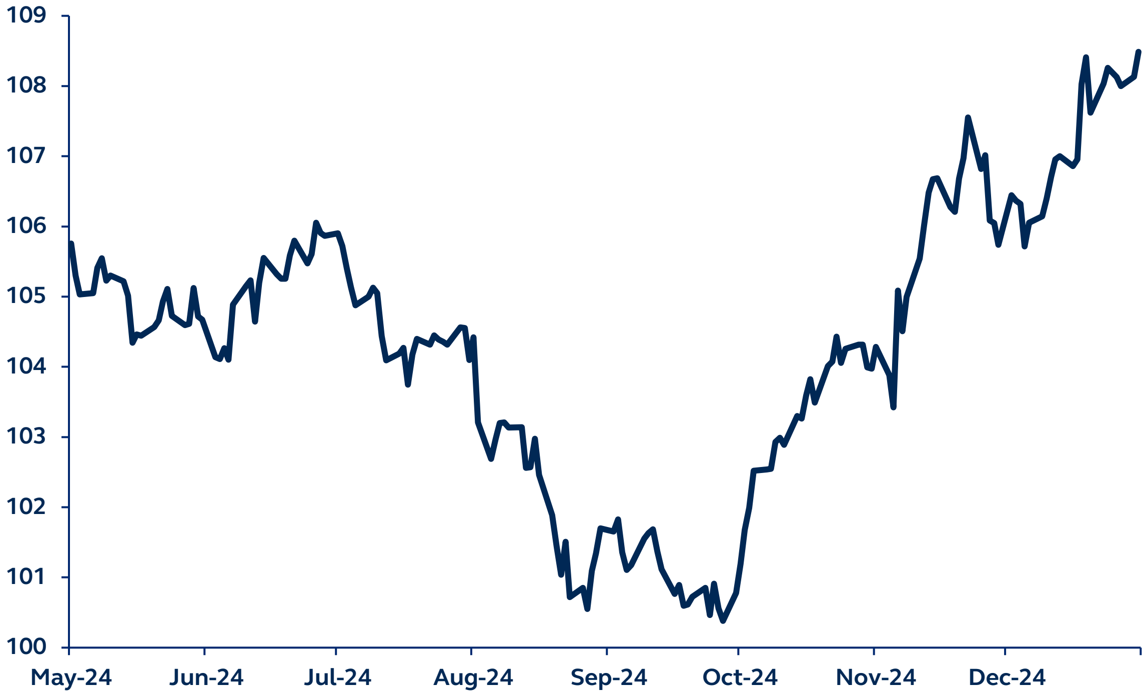
January 2021–present, forecasted through 2025



Source: Federal Reserve, European Central Bank, Bank of England, Principal Asset Management. Data as of December 12, 2024.

U.S. dollar Spot Index

May 2024–present



Source: Bloomberg, Principal Asset Management. Data as of December 31, 2024.

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Investment Perspectives

A cautiously risk-on environment for investors

Despite elevated policy uncertainty, a solid economic backdrop implies this is still a risk-on investing opportunity.

Equities *Retain U.S equity exposure but add diversification via global equities*

- Strong U.S. earnings growth is likely to overcome valuations concerns and deliver solid equity market gains.
- Explore opportunities beyond the Mag 7, including tactical exposure to small- and mid-cap stocks.
- Pockets of attractive international valuations suggest opportunities outside the U.S

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 and reinvestment risks.
- Emerging market debt may offer total return potential during global central bank easing.
- High yield maintains a substantial carry advantage for income-seeking investors.

Alternatives *Pursue less correlated exposures*

- Real return-focused strategies gain attractiveness when nominal growth slows and inflation is sticky.
- Infrastructure offers resiliency and attractive valuations.
- REITs offer attractive valuations and constructive fundamentals as rates move lower.
- When valuations are expensive, reduce overall risk and focus on alpha capture.

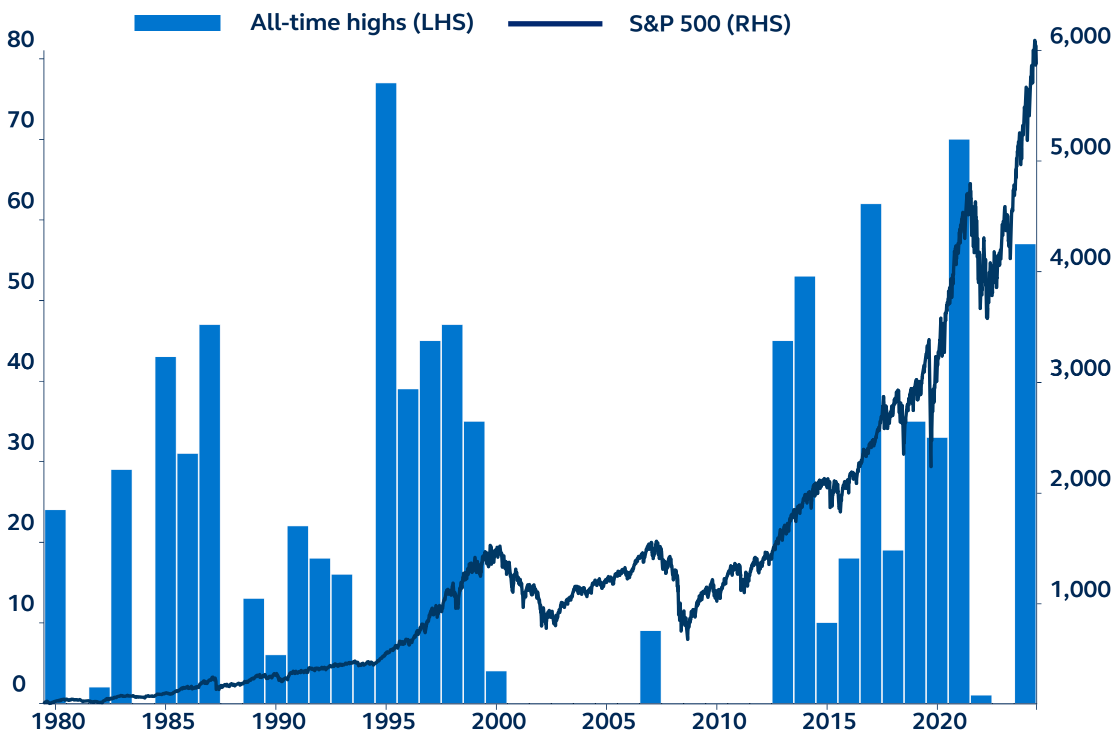
Equities

U.S. equities: Climbing the valuation wall

Extended valuations and elevated bond yields present U.S. equities with a challenging environment but, provided earnings growth is strong, U.S equities is likely to deliver solid gains.

Stock market all-time highs

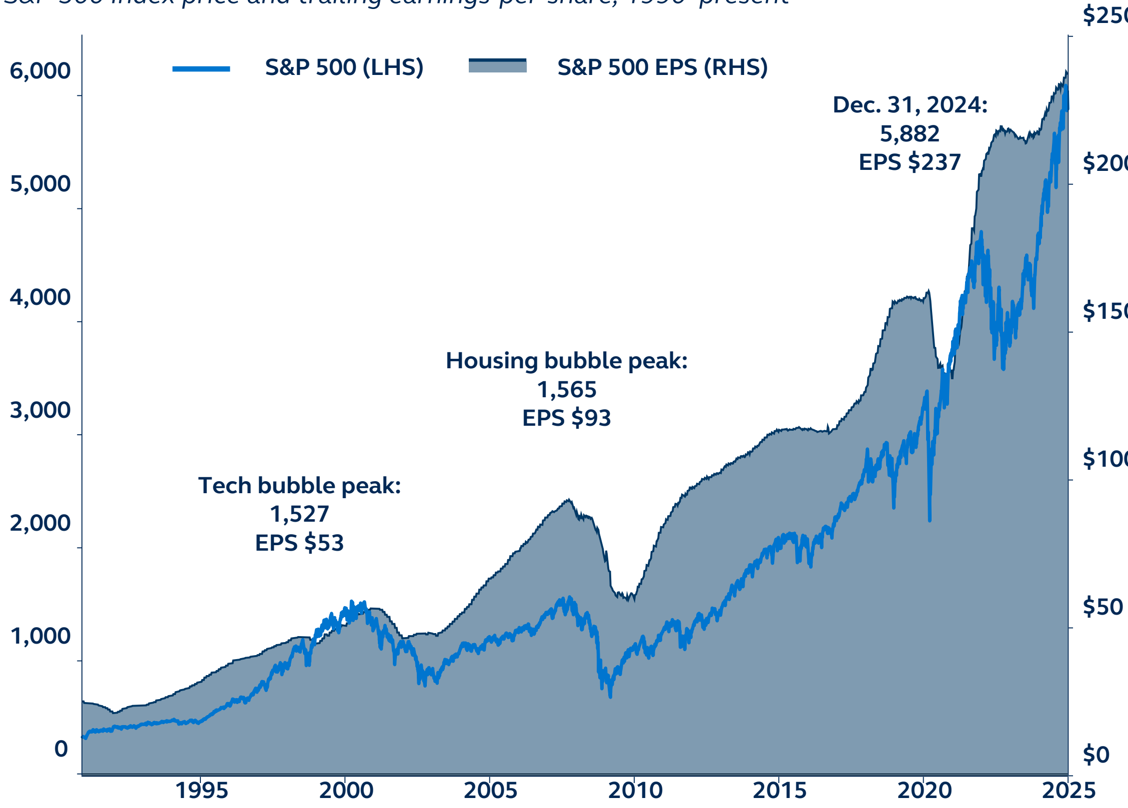
The number of S&P 500 all-time highs each year



Source: Clearnomics, Standard & Poor's, Bloomberg, Principal Asset Management.
Data as of December 31, 2024

The stock market and earnings

S&P 500 Index price and trailing earnings-per-share, 1990–present



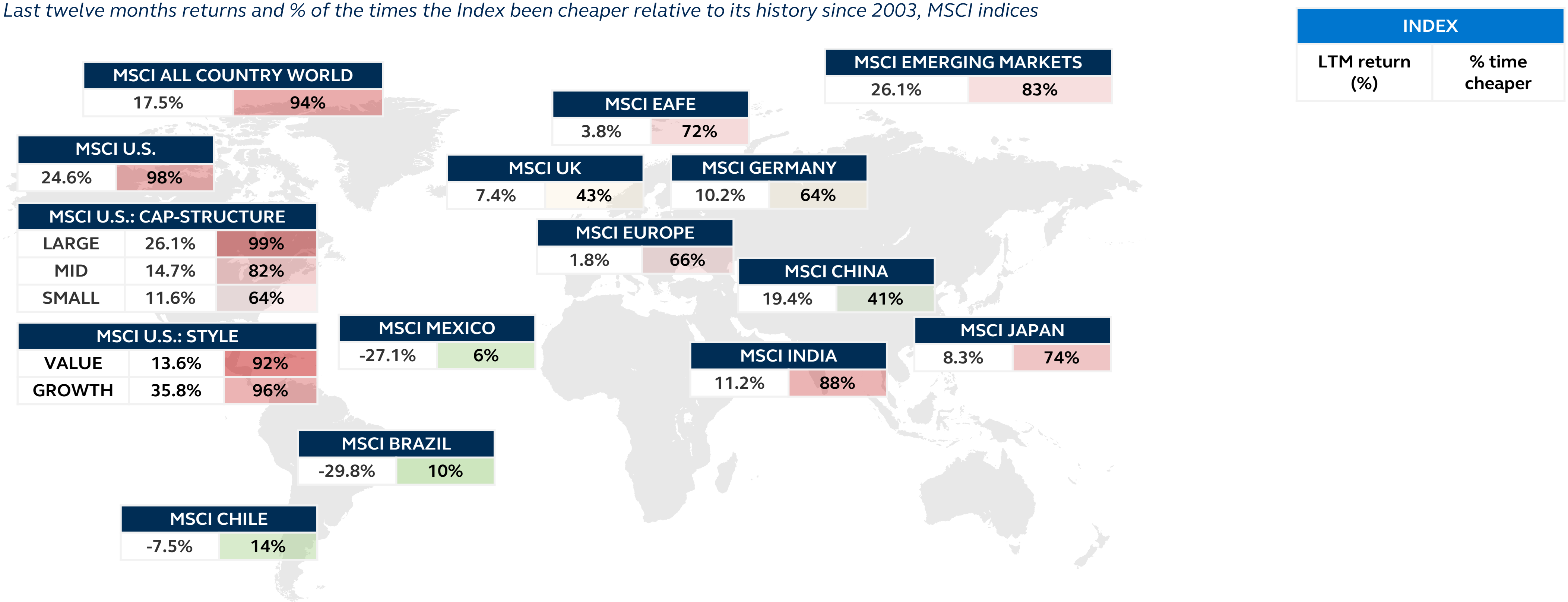
Source: Clearnomics, Standard & Poor's, Bloomberg, Principal Asset Management.
Data as of December 31, 2024.

Investors should consider the divergent global picture

Expensive valuations across U.S. equities mean investors should consider other global regions, but still retaining a focus on strong fundamentals

Global equity returns and valuations

Last twelve months returns and % of the times 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 December 31, 2024.

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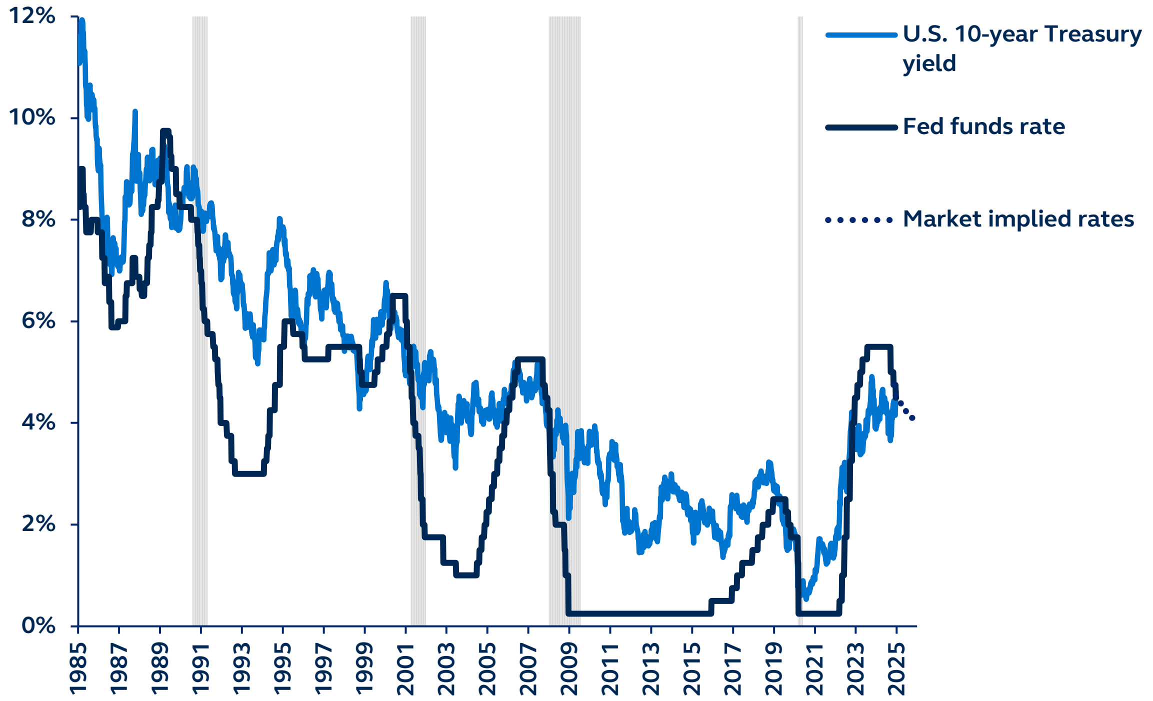
Fixed Income

Bond yields: trending higher, counter to historic Fed cycles

While history suggests Fed cuts and a slowing economy should push yields lower, bond yields have been trending higher in response to a multitude of factors.

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

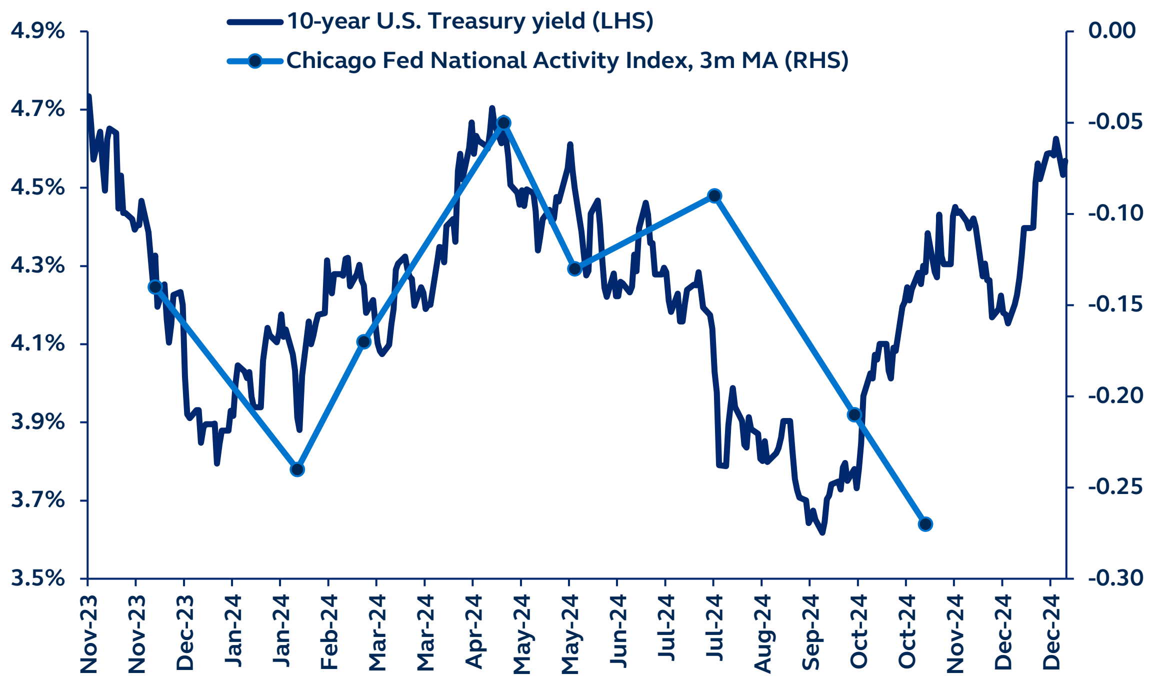
Recessions are shaded, 1985–present



Source: Federal Reserve, Bloomberg, Principal Asset Allocation. Data as of December 31, 2024.

10-year Treasury yield and economic activity

November 2023–present



Source: Bloomberg, Principal Asset Management. Data as of December 31, 2024.

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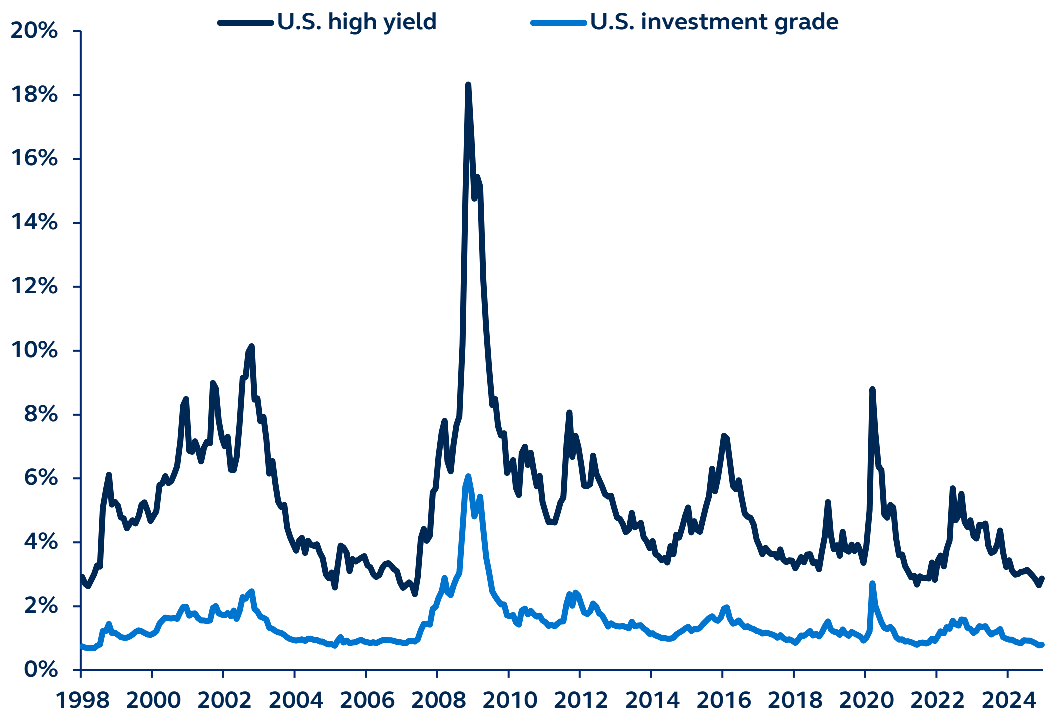
Despite tight spreads, credit may generate strong returns

Credit spreads are near historic tights. But solid fundamentals and elevated starting yields imply credit could generate strong returns in 2025.

U.S. high yield and investment grade spreads

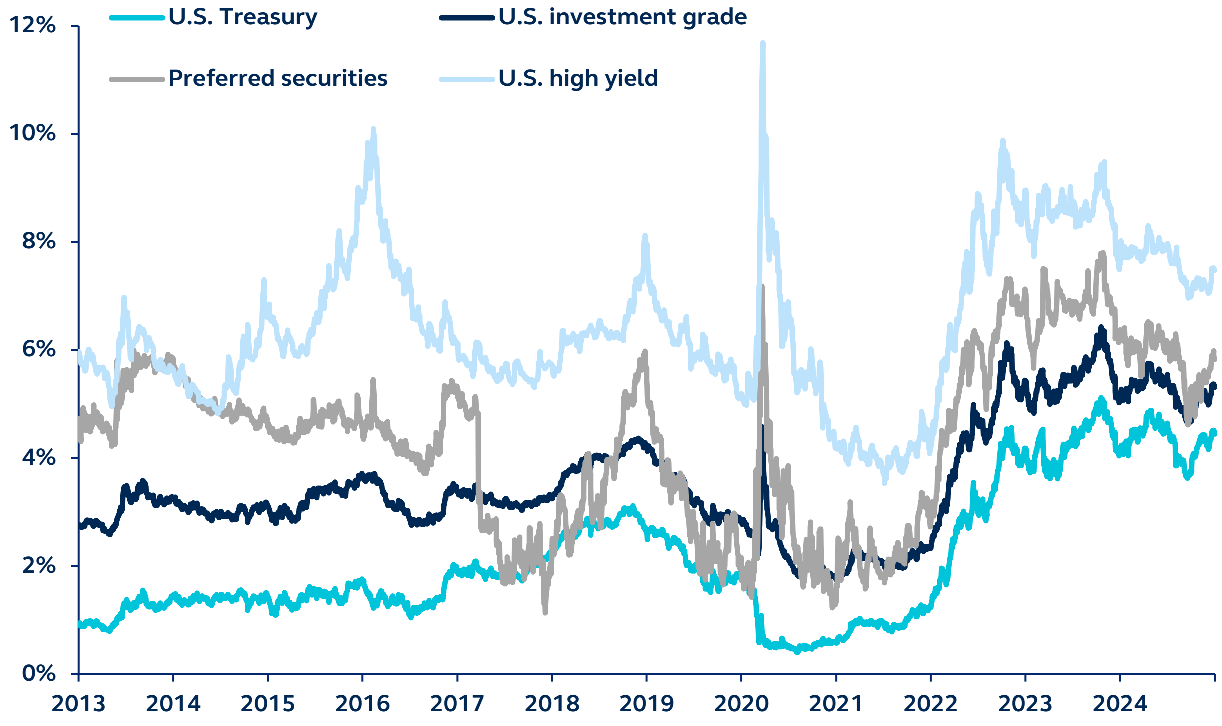
Option-adjusted-spread, 1998–present



Source: Bloomberg, Principal Asset Management.
Data as of December 31, 2024.

Yield comparison

Yield-to-worst, 2013–present



Source: J.P. Morgan, Principal Asset Management. Data as of December 31, 2024

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