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Principal Hong Kong
3Q 2024 Market Outlook

Diversified asset allocation: Positioned for risk on

Key themes

- **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 may occur in September, provided inflation continues to decelerate and economic activity does not reaccelerate. Other central banks have started easing, but their next moves may fall back in line with the Fed's actions.

- **Equity markets may 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 may be the leading risk.**
  Assets in money market funds have ballooned to a record $6 trillion, with investors attracted by elevated yields. Now, this cash may represent a potential tailwind to risk assets.

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	○	○	●	○	○
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	○	○	○	●	○

Viewpoints reflect a 12-month horizon.
◌ → ● indicates a change in preference from the previous quarter (light blue) to the current quarter (darker blue).

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.

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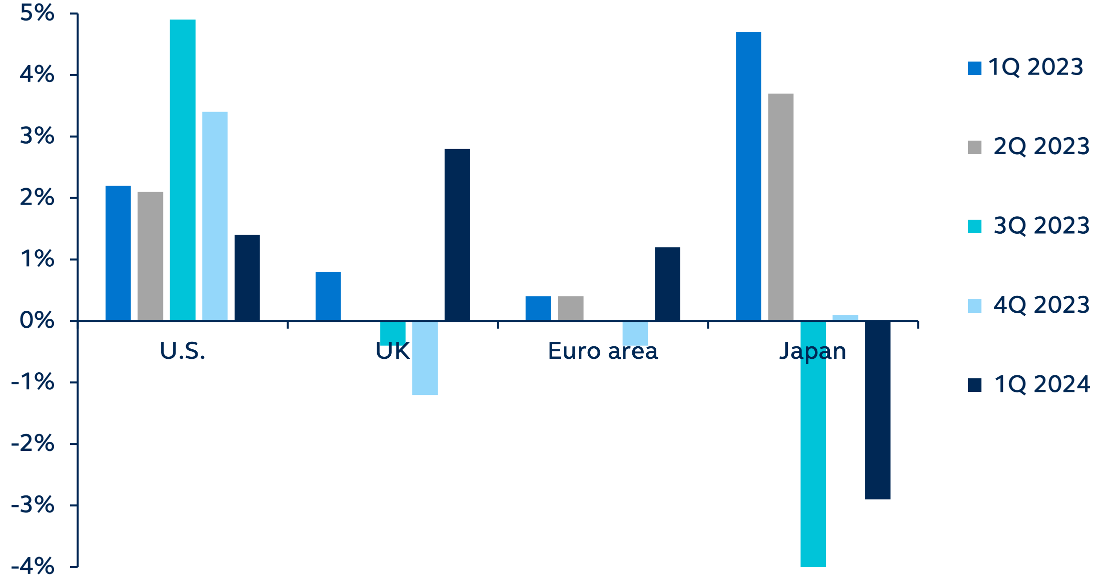
Global economic growth broadens beyond the U.S.

Global growth has broadened beyond just the U.S. But the limited nature of the upturn implies U.S. dominance remains.

Global growth

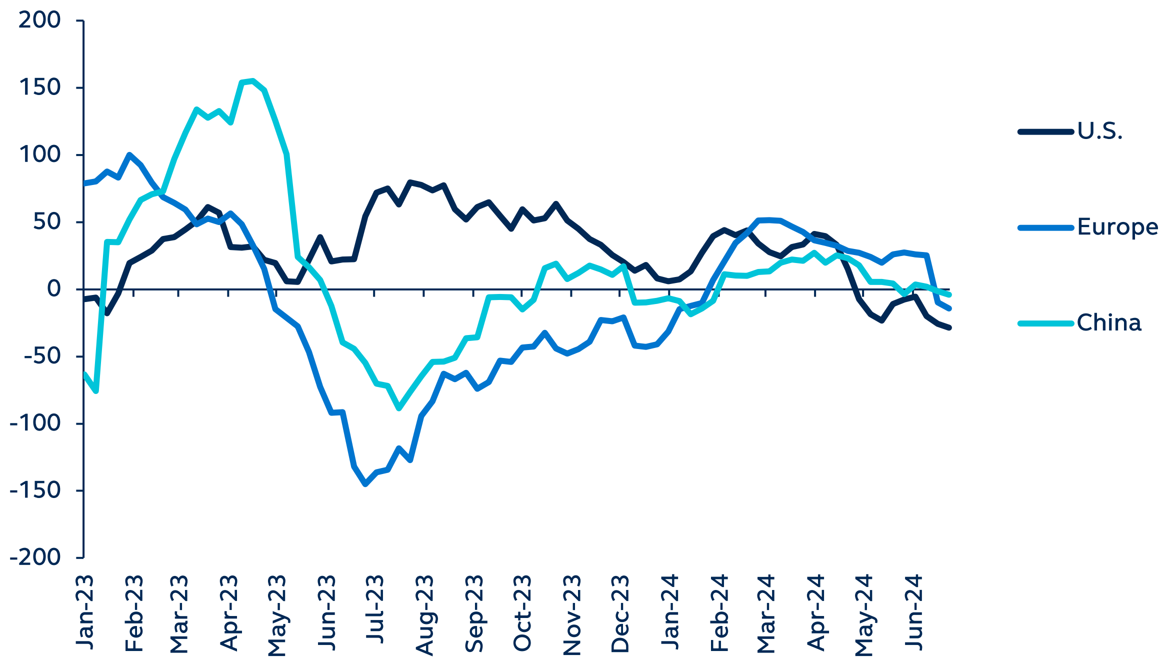
Quarterly, 1Q 2023–1Q 2024



Source: Federal Reserve Bank of New York, Bloomberg, Principal Asset Management. Data as of June 30, 2024.

U.S, Europe, and China economic surprises

Citi Economic Surprise Index level, weekly, 2023–present



Source: Bloomberg, Citi, Principal Asset Allocation. Data as of June 30, 2024.

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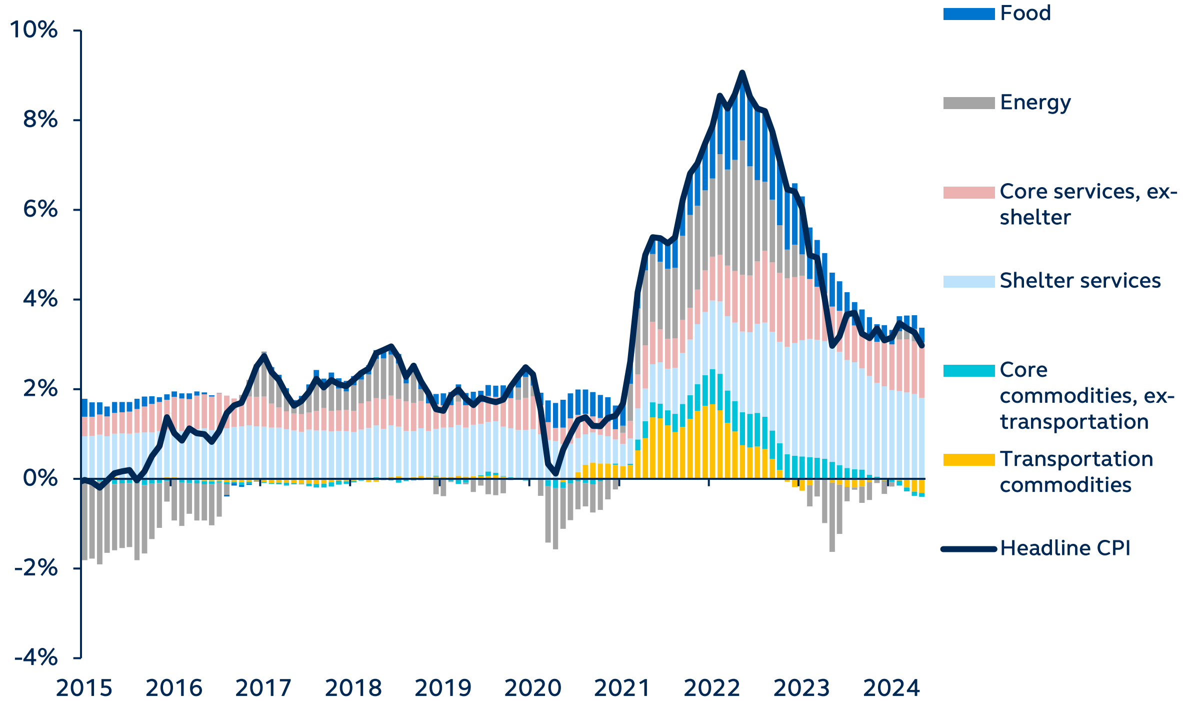
Global inflation: A frustratingly slow last mile

The last mile to central banks' inflation targets is proving tough and may require some (small) cracks in the labor markets to materialize.

Contribution to headline U.S. inflation

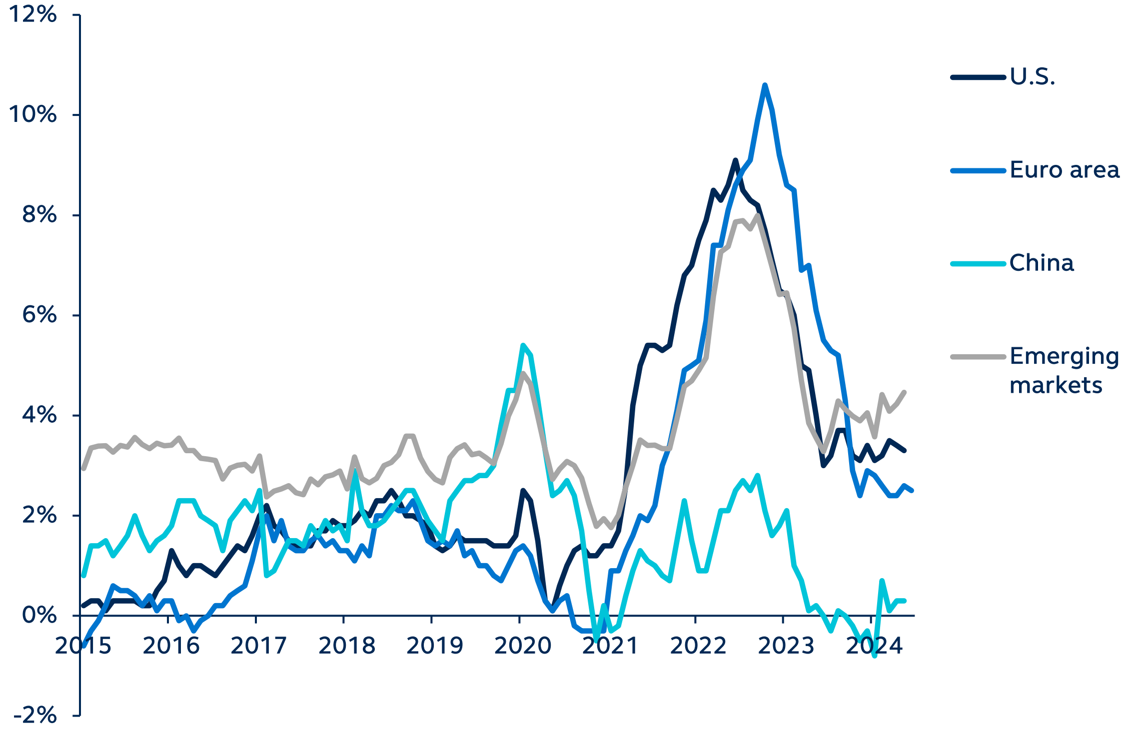
Year-over-year, January 2015–present



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

Global inflation rates

Principal Asset Allocation GDP-weighted inflation, 2015–present



Note: Emerging markets calculated using GDP weights.
Source: Bloomberg, Principal Asset Management. Data as of June 30, 2024.

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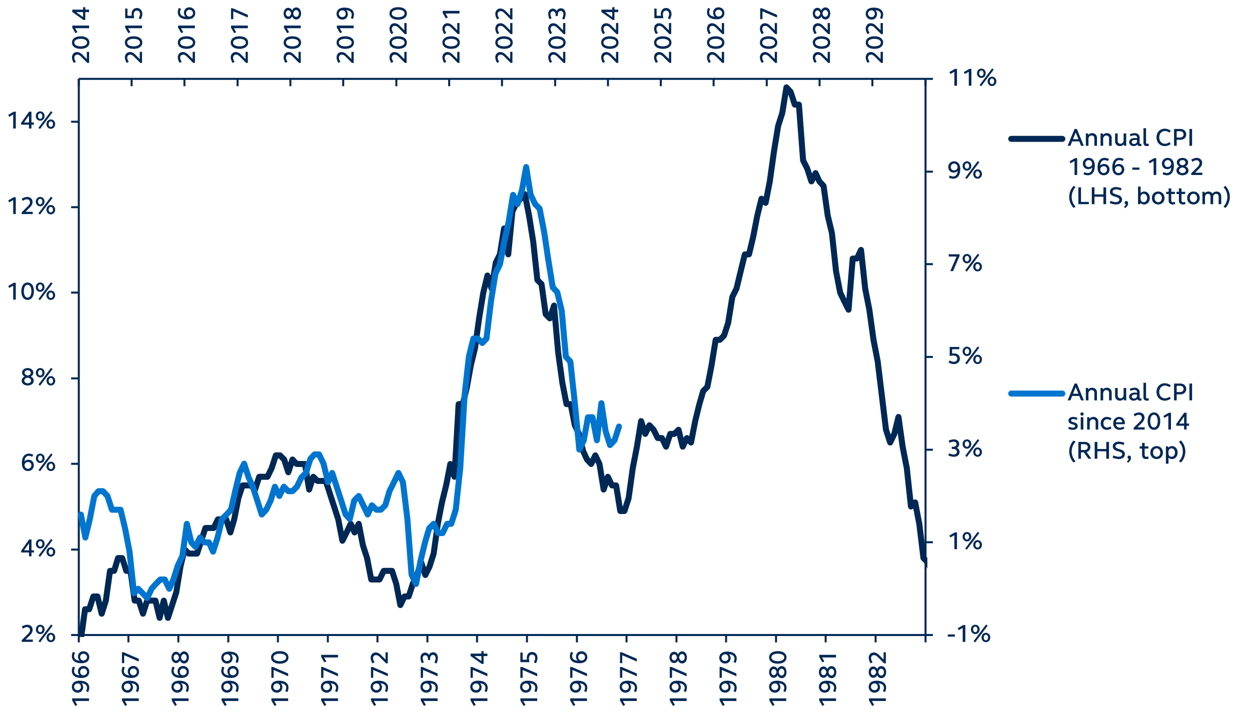
The Fed policy path: A fork in the road

The Fed is confronting the harsh reality that resilient economic activity cultivates sticky, stubborn inflation. Incoming data is pivotal to the near-term policy decisions.

Historical inflation comparison

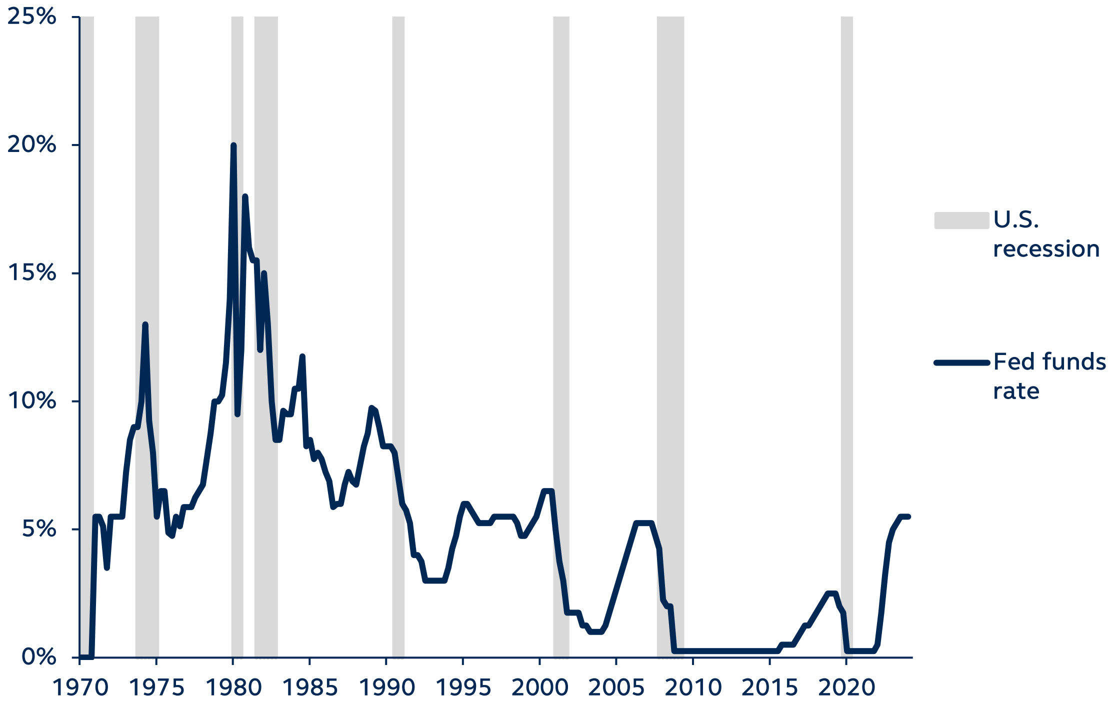
Consumer Price Index (CPI)



Source: Bureau of Labor Statistics, Principal Asset Management. Data as of June 12, 2024.

Real Fed funds rate and recessions

1970–present



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

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Federal Reserve: Closing in on rate cuts

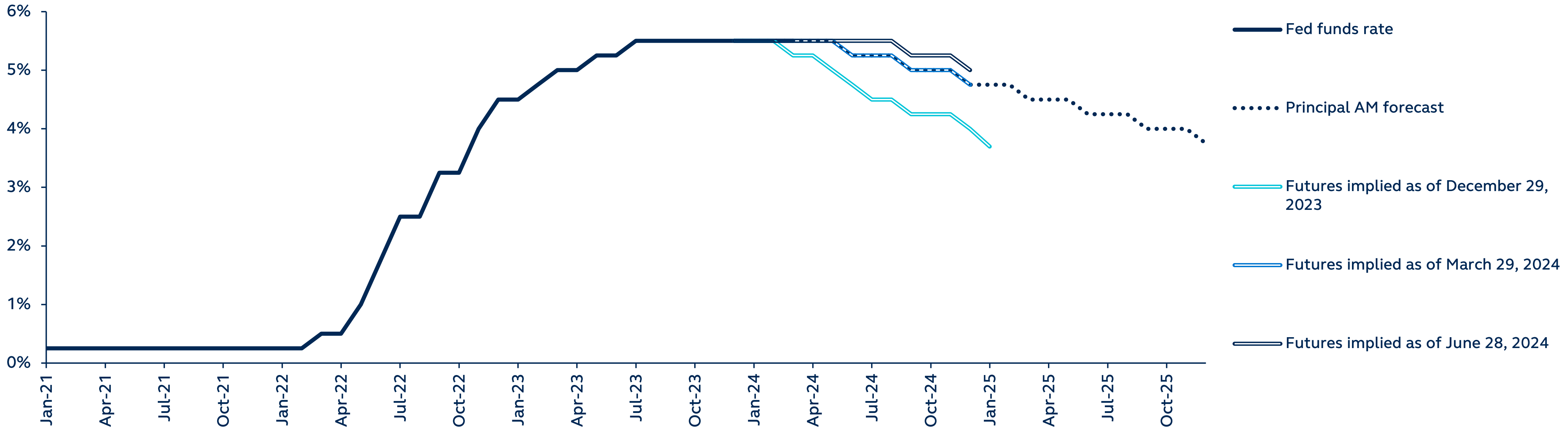
We expect cuts in September and December, but that requires convincing and consistent evidence of slowing economic activity, a weaker labor market, and softening inflation.

Investors can derive three key insights for the Fed's outlook:

- Recent consumer and labor market survey data suggest that the next policy move will be a cut, not a hike.
- With just four FOMC meetings remaining in 2024 and inflation still above the Fed's comfort zone, markets are unlikely to get more than two policy rate cuts this year.
- While inflation is likely to decelerate, the economy's underlying strength, geopolitical tensions, and several structural drivers argue against a meaningful drop in inflation. This is likely shaping up to be a short and shallow cutting cycle.

Federal Reserve policy rate path

Fed funds rate and projections, 2021–present



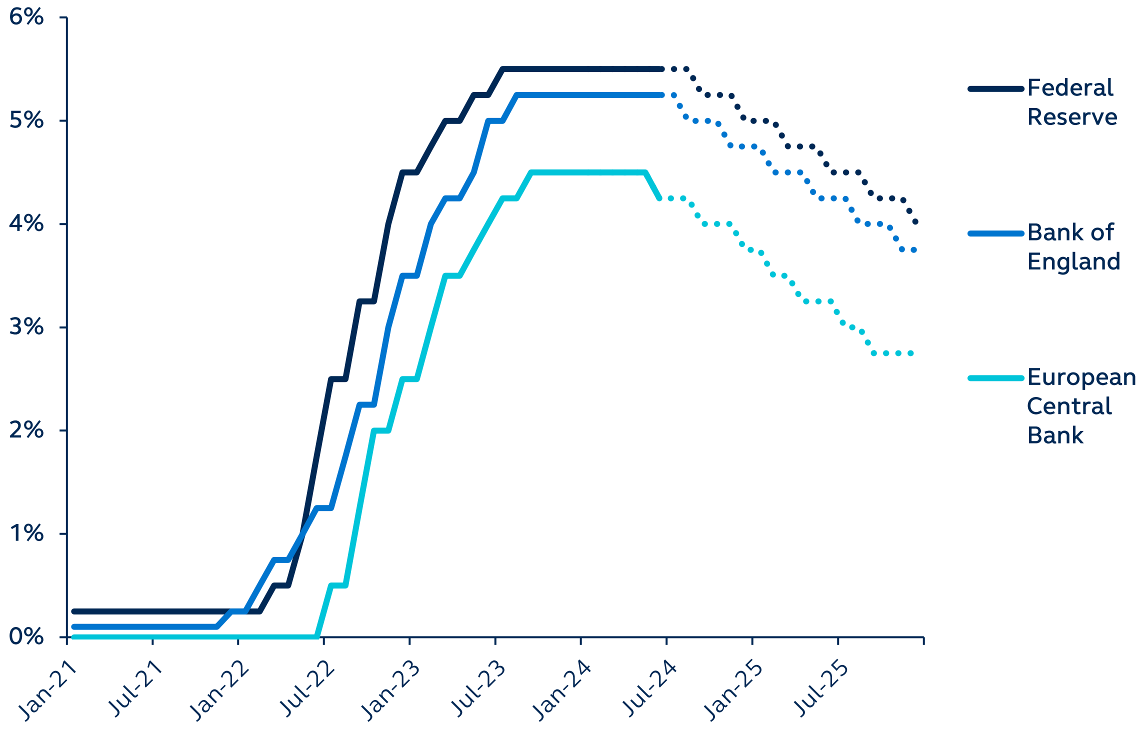
Source: Federal Reserve, Bloomberg, Principal Asset Management. Data as of June 30, 2024.

Global central banks: Divergent, but not for long

Given signs of sticky inflation, the ECB and BoE's policy paths are unlikely to be more dovish than the Fed's. The BoJ will need to move towards hikes to avoid further yen weakness.

Global central bank rates

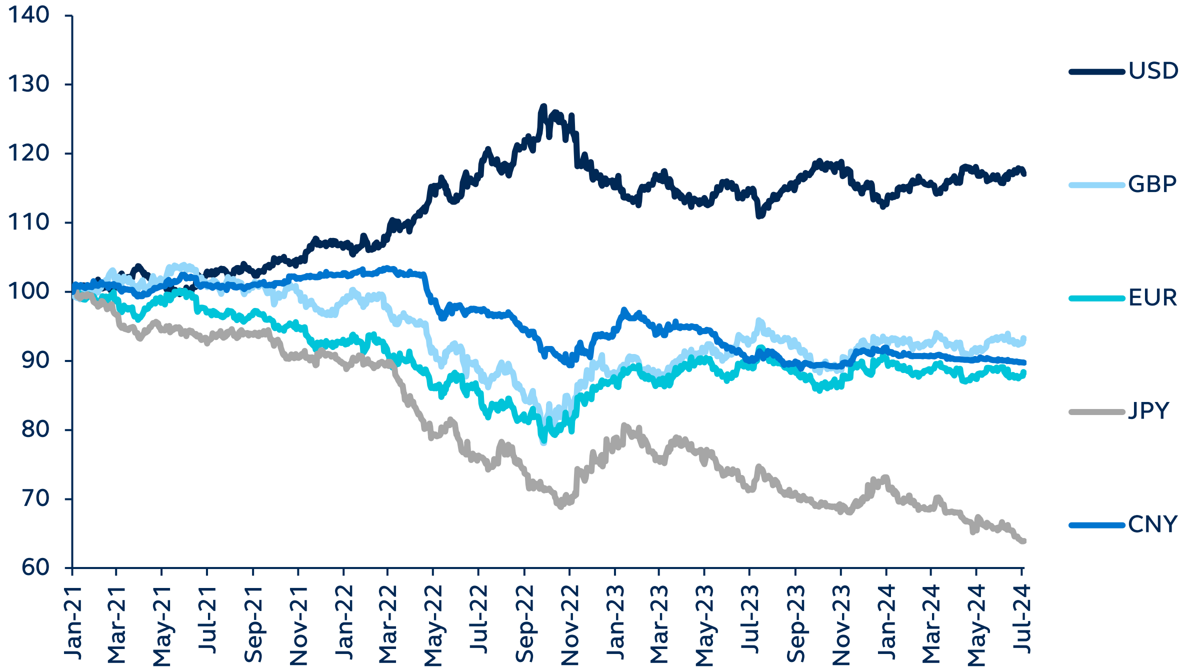
January 2021–present, forecasted through 2025



Source: Federal Reserve, European Central Bank, Bank of England, Principal Asset Management. Data as of June 30, 2024.

Major currencies

Rebased to 100 at January 2021



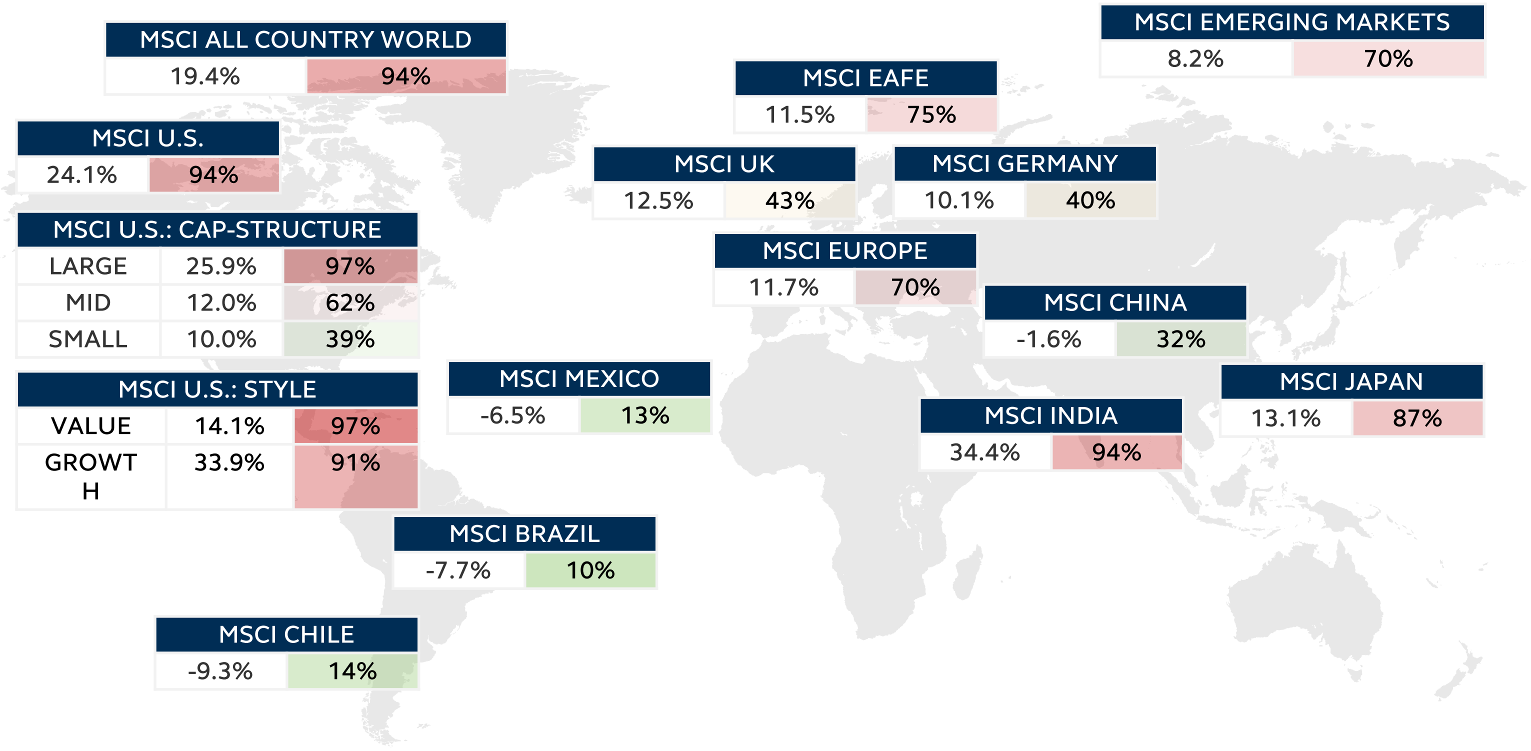
Source: LSEG, Bloomberg, Principal Asset Management. Data as of July 4, 2024.

Global equity valuations: Looking beyond the U.S.

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



INDEX	
LTM return (%)	% time cheaper

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.

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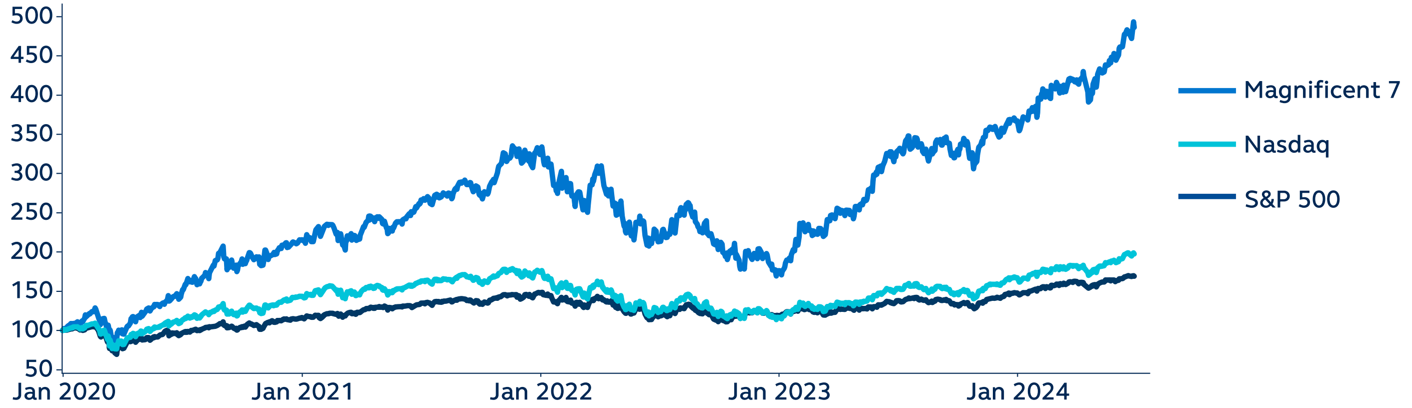
Equities: Our positioning remains overweight

Magnificent 7 performance

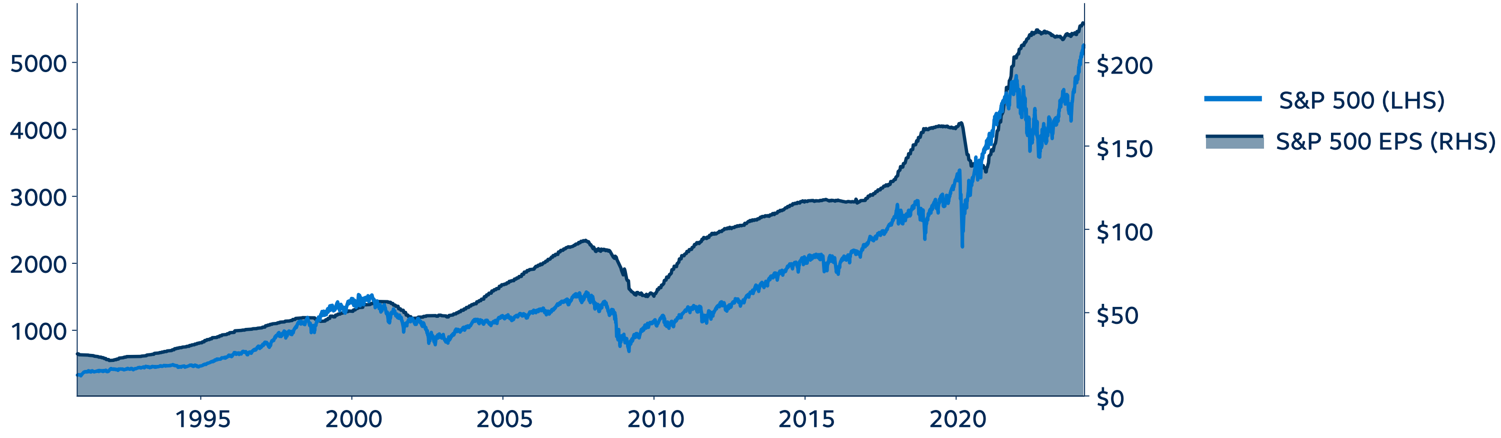
Simple equal-weighted performance versus the S&P 500 and Nasdaq composite, indexed to 100 at January 1, 2020



Source: Clearnomics, Standard & Poor's, Nasdaq, Principal Asset Management. Data as of June 30, 2024.

The stock market and earnings

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



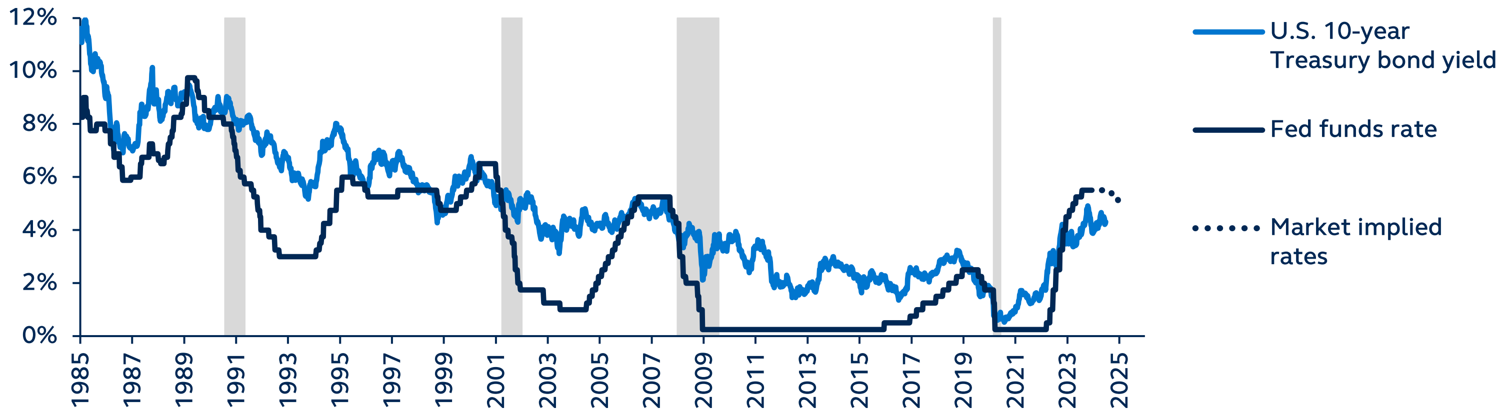
Source: Clearnomics, Standard & Poor's, Bloomberg, Principal Asset Management. Data as of June 30, 2024.

- The AI craze and delivery of strong earnings means that investors are still willing to pay higher multiples for those companies. Stretched valuations and very concentrated positioning may imply the Magnificent 7 only grind higher from here, but the secular trend upwards may persist over the long run. Furthermore, solid economic growth should support a broadening out of risk appetite and earnings growth across a variety of other companies, sectors, and markets which are meaningfully less stretched and, therefore, offer the potential for strong returns.
- 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.
- 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.

Fixed Income: Our positioning shifts to neutral

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

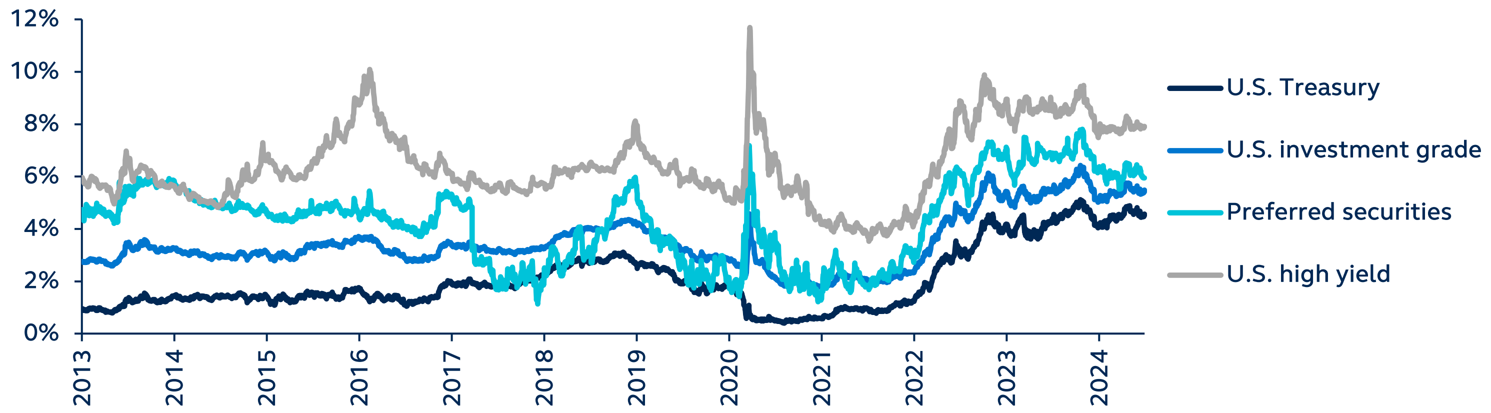
Recessions are shaded, 1985–present



Source: Clearnomics, Federal Reserve, Bloomberg, Principal Asset Management. Data as of June 30, 2024.

Yield comparison

Yield-to-worst, 2013–present



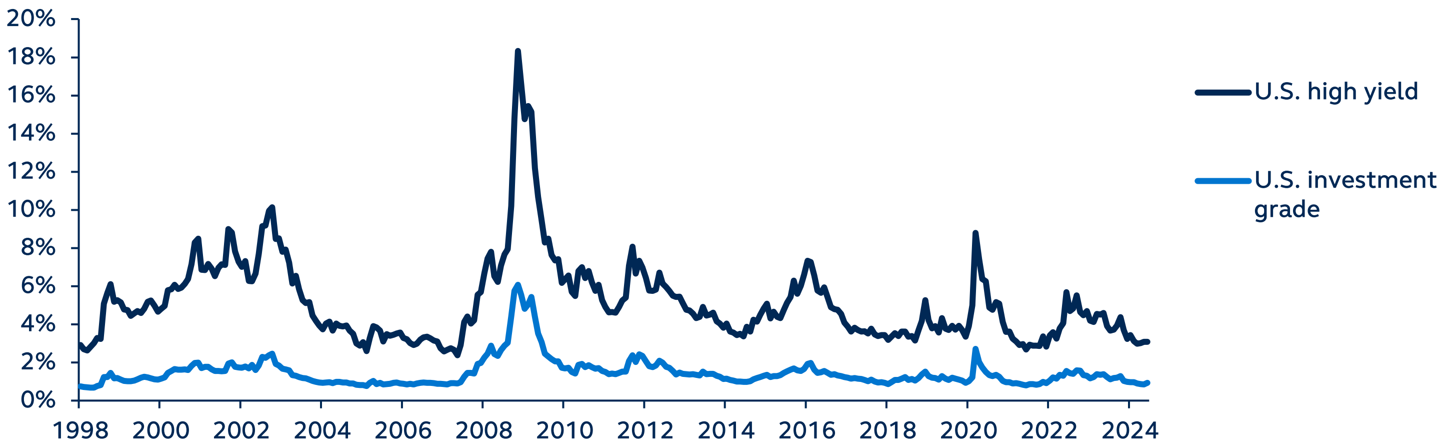
Source: Bloomberg, Principal Asset Management. Data as of June 30, 2024.

- The second quarter of 2024 proved to be volatile for sovereign bonds as markets debated central bank policy paths. With investors pricing in a more gradual cycle of rate cuts in most economies, sovereign yields rose through 2Q, and 10-year U.S. Treasury yields ended the quarter 20 basis points higher than they started. Election risk has also played its part. Markets have focused on the risks of looser fiscal stances, putting upward pressure on longer-end bond yields, steepening the yield curve.
- With the Fed likely to start cutting rates later this year, Treasury yields should skew lower. However, the likely short and shallow Fed cutting cycle, coupled with elevated market scrutiny on fiscal sustainability, suggests that yields are unlikely to revert to the ultra-low levels of recent years.
- Despite the significant repricing in rate expectations so far in 2024, fixed income has continued to deliver positive performance, predominantly because the macro resilience narrative remains intact. More pertinently, the total yield generated from fixed income today is markedly higher than a few years ago, and credit is offering important additional carry to U.S. Treasurys.

Fixed income

U.S. high yield and investment grade spreads

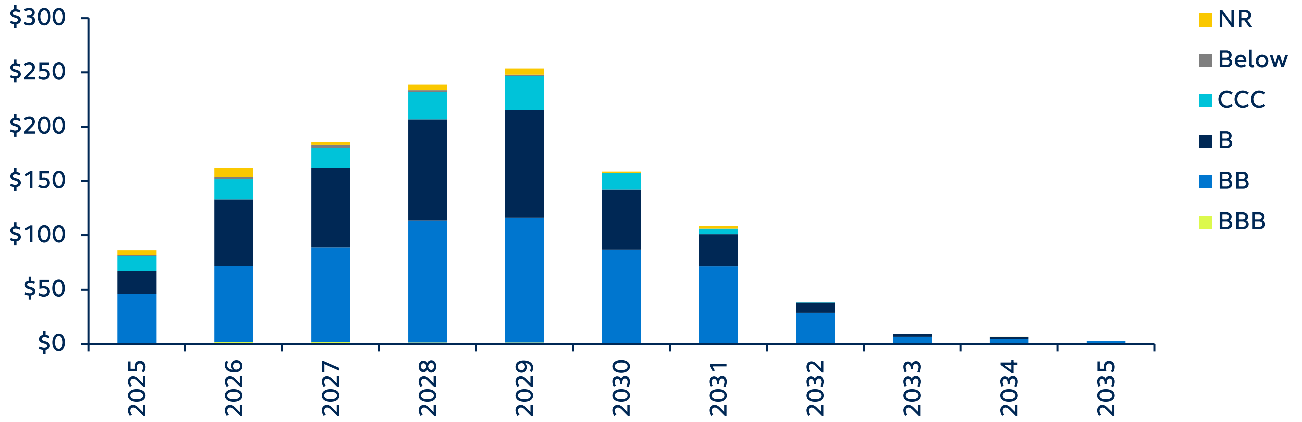
Option-adjusted-spread, 1998–present



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.

- 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 may be able to digest the interest rate costs without too much strain.

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