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Principal Hong Kong
2Q 2024 Market Outlook

2Q 2024 Global Asset Allocation Viewpoints

Key themes

- **The U.S. economy stands out from the crowd.**
  U.S. growth is downshifting somewhat as lower income households pull back, and corporates face higher refinancing costs. However, with most other global economies still struggling, the U.S. may remain the strongest global performer.

- **Global disinflation is showing signs of stalling.**
  After having made significant progress last year, inflation deceleration has flattened out. The last mile of disinflation toward central bank targets would require some economic slowdown and job market rebalancing.

- **Central banks believe they can cut rates without sacrificing inflation.**
  The Fed wants to cut policy rates, but it may be fazed by recent inflation surprises. It will likely cut policy rates two times this year, starting in September. Other central banks may also begin easing soon but may cut with greater urgency.

- **Equities may continue embracing the soft-landing narrative.**
  The constructive backdrop of solid growth, positive earnings and prospective rate cuts has been fueling market optimism. This mix may also support a broadening of the market rally as rate cuts come closer into sight.

- **Fixed income yields are relatively attractive compared to equity yields.**
  U.S. Treasury yields should skew lower as the Fed begins cuts but may be limited by the shallow easing cycle. While credit spreads are tight, providing recession is avoided, they might not widen much and still provide meaningful carry opportunities.

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 local currency	○	○	○	●	○
Emerging market hard currency	○	○	●	○	○
Alternatives					
Commodities	○	○	●	○	○
Natural resources	○	○	●	○	○
Infrastructure	○	●	← ◎	○	○
REITs	○	○	●	← ◎	○
Hedge funds	○	○	○	●	○

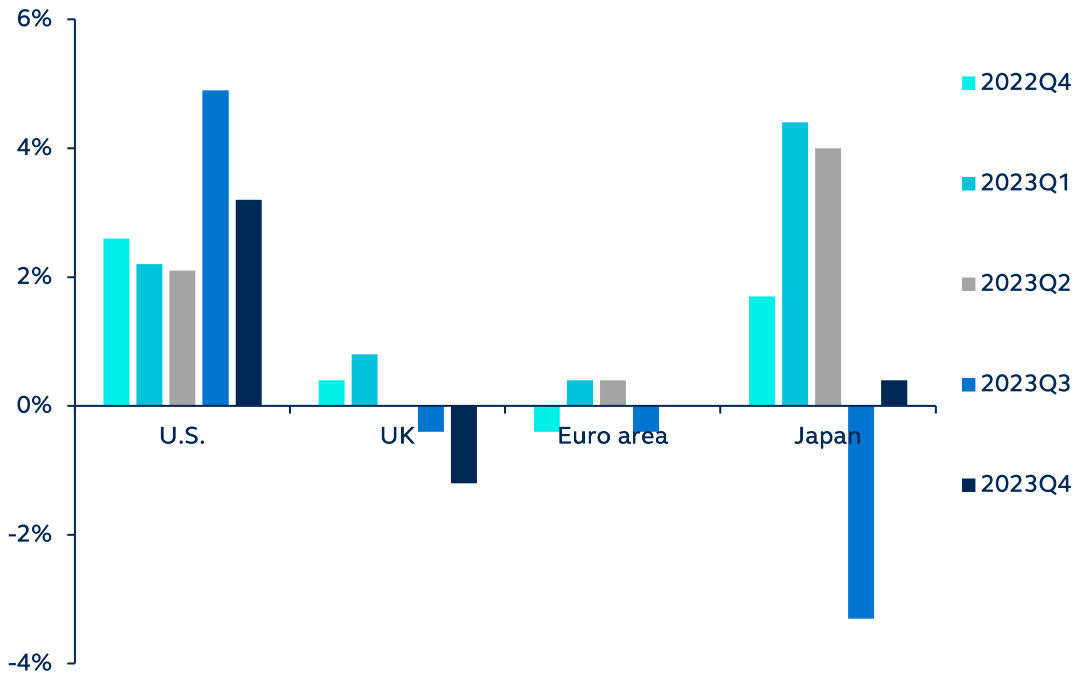
Viewpoints reflect a 12-month horizon.
◎→● indicates a change in preference from the previous quarter (light blue) to the current quarter (darker blue).

Global economy: U.S. stands out from the crowd

The U.S. is likely set to outperform its global peers once again. While Europe and China struggle to make significant headway, the U.S. economy is heading for a soft landing.

Global growth

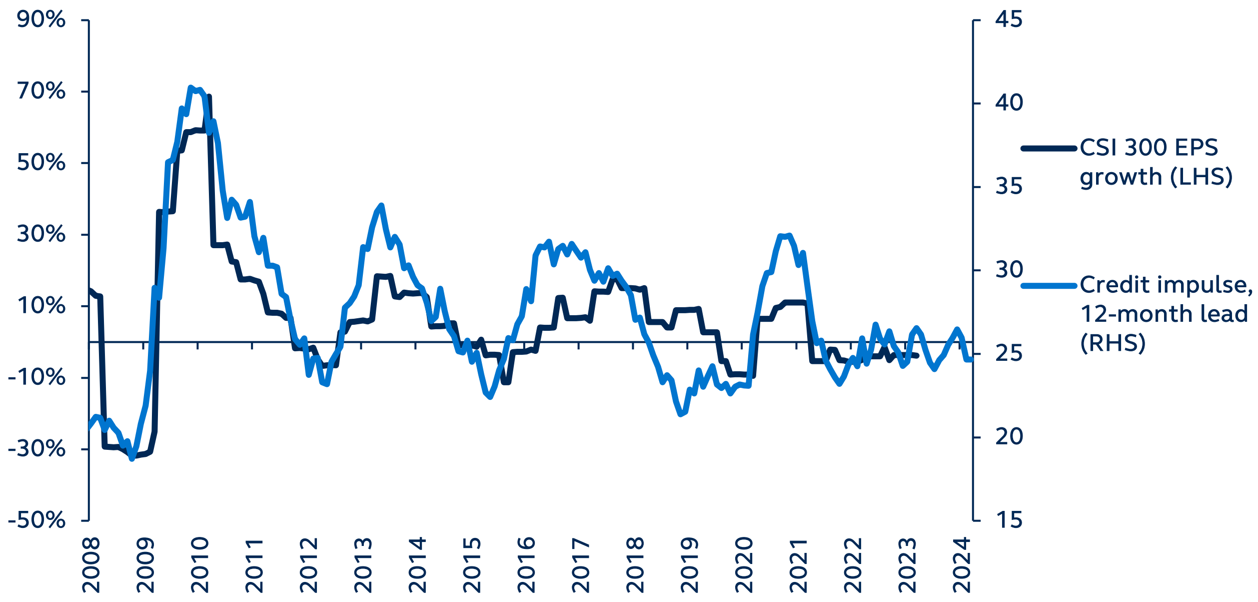
Quarterly, 4Q 2022–4Q 2023



Source: Federal Reserve Bank of New York, Bloomberg, Principal Asset Management. Data as of March 31, 2024.

China credit impulse versus earnings growth

2008–present



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

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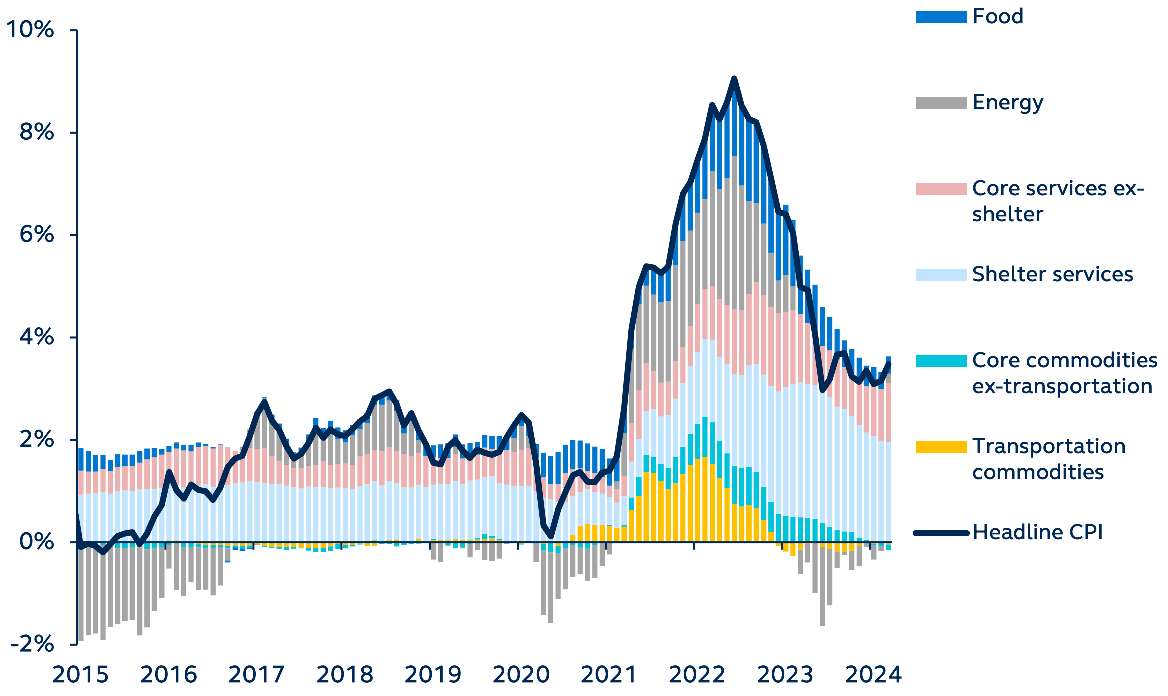
Global inflation: A frustratingly slow last mile

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

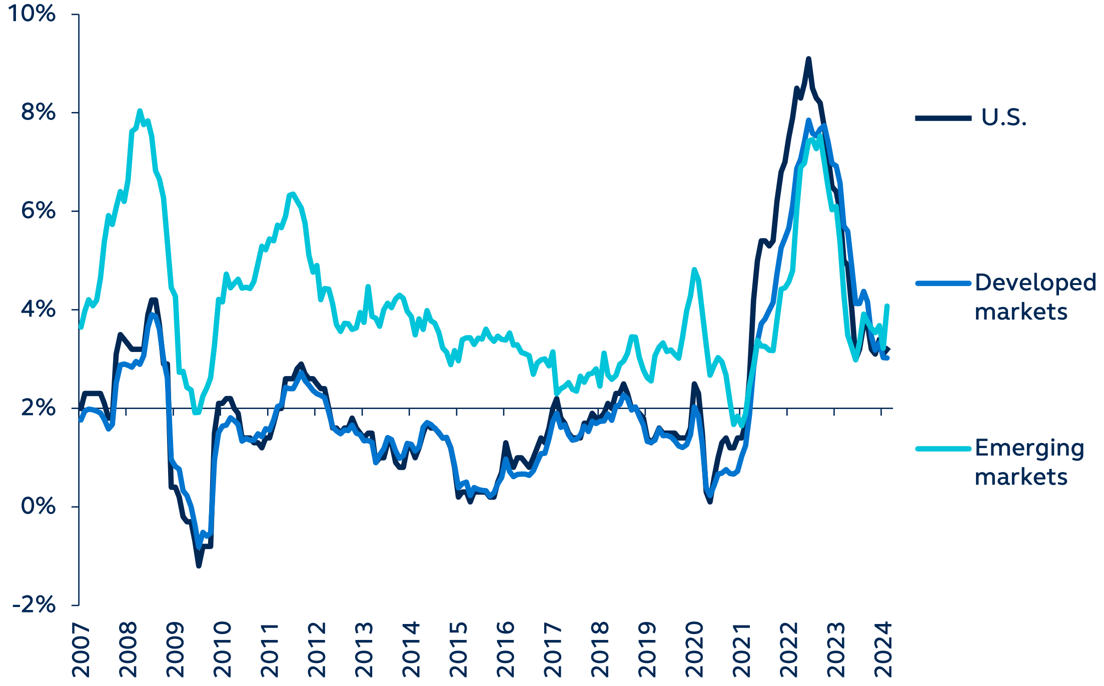
Year-over-year, January 2015–present



Source: Bureau of Labor Statistics, Principal Asset Management. Data as of April 10, 2024.

Principal Asset Allocation GDP-weighted inflation

January 2007–present



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

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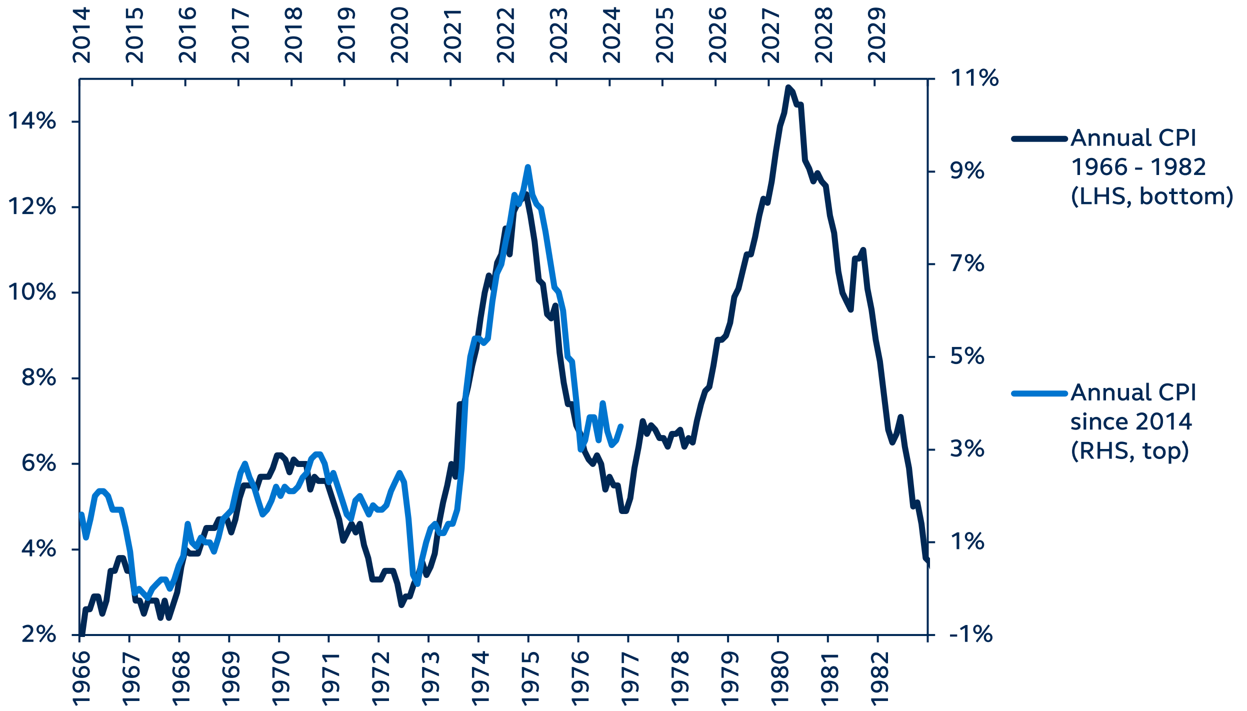
Policymakers should carefully navigate the landing

The Fed should tread carefully to ensure it does not trigger a new inflation wave. However, leaving policy rates unchanged for too prolonged a period would raise recession risk.

Historical inflation comparison

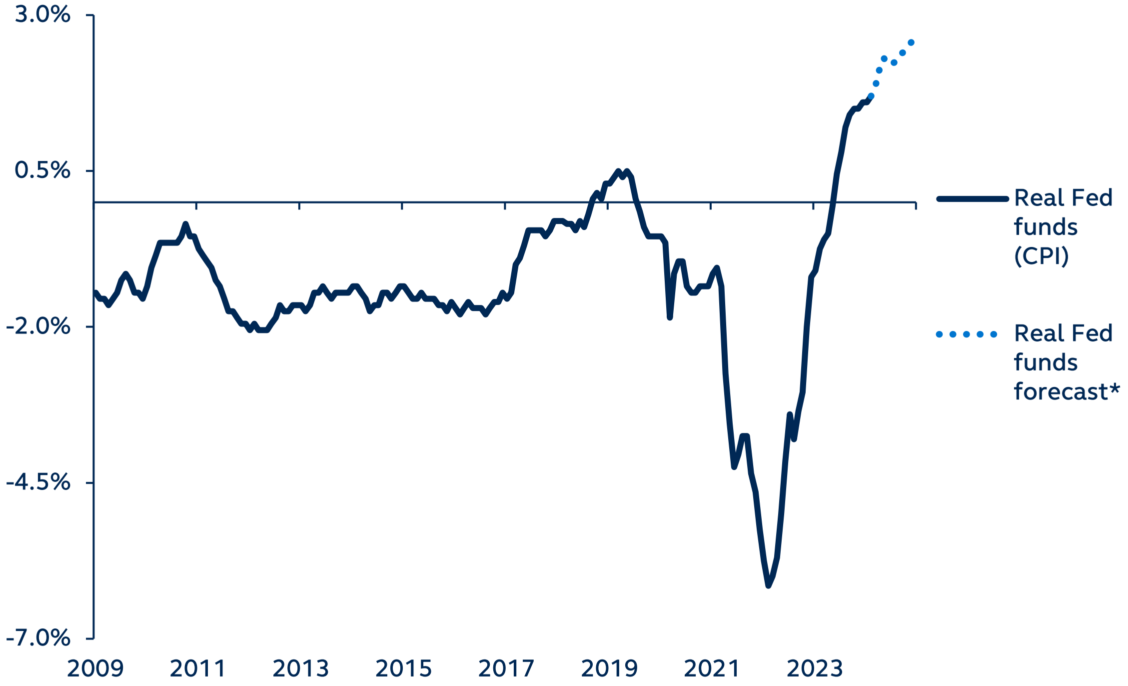
Consumer Price Index (CPI)



Source: Bureau of Labor Statistics, Principal Asset Management. Data as of April 10, 2024.

Real Fed funds rate

January 2009–present



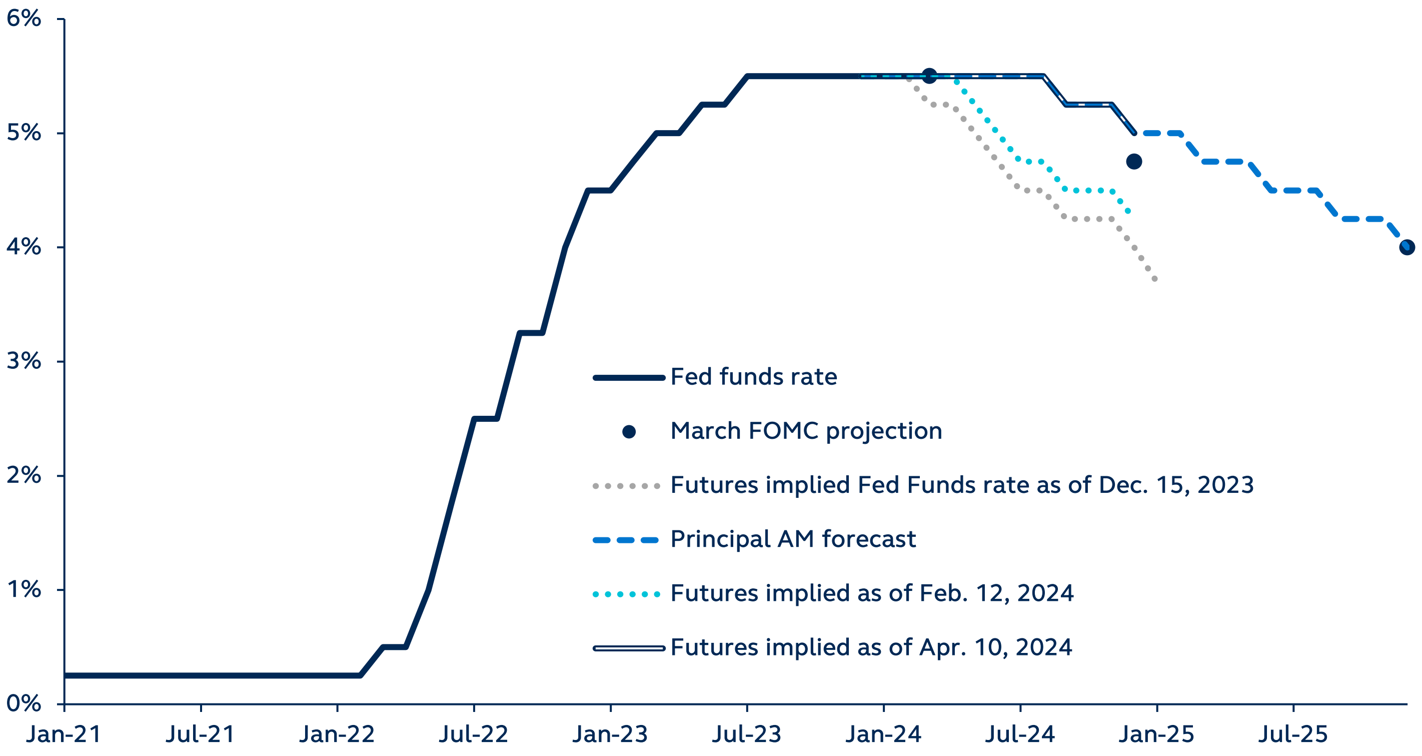
*Assuming Fed funds held at 5.5% and using headline CPI forecast.
Source: Federal Reserve, Bureau of Labor Statistics, Bloomberg, Principal Asset Management. Data as of March 31, 2024.

Federal Reserve: Eager to cut rates

The Fed clearly wants to cut rates. We are expecting two rate cuts in 2024, starting in September. However, loosening policy at a time when growth is still strong is a risky strategy.

Federal Reserve policy rates path

Fed funds rate and projections, 2021–present



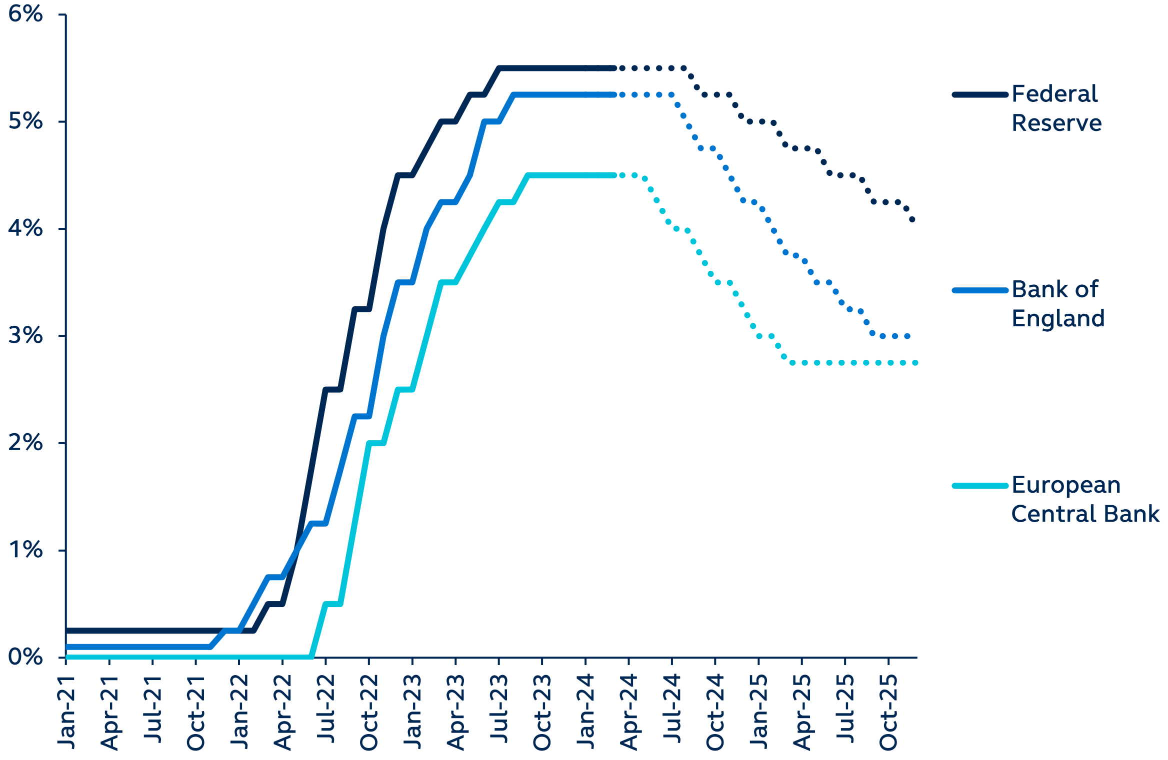
Source: Federal Reserve, Bloomberg, Principal Asset Management. Data as of April 10, 2024.

Global central banks: More reason to cut than the Fed

Global central banks would prefer to start cutting rates at the same time as the Fed. Yet their weaker economies mean they may move with greater urgency. Their relatively dovish policy path may keep upward pressure on the U.S. dollar.

Global central bank rates

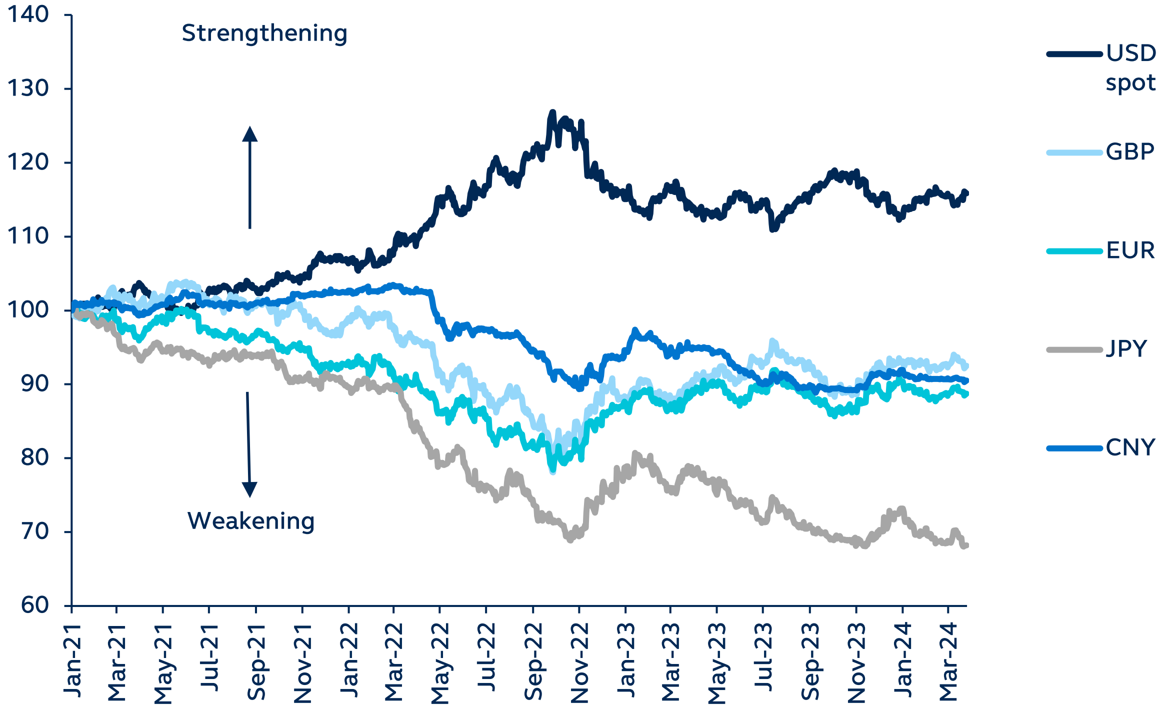
January 2021–present, forecasted through 2025



Source: Federal Reserve, European Central Bank, Bank of England, Principal Asset Management. Data as of April 10, 2024.

Major currencies

Rebased to 100 at January 2021



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

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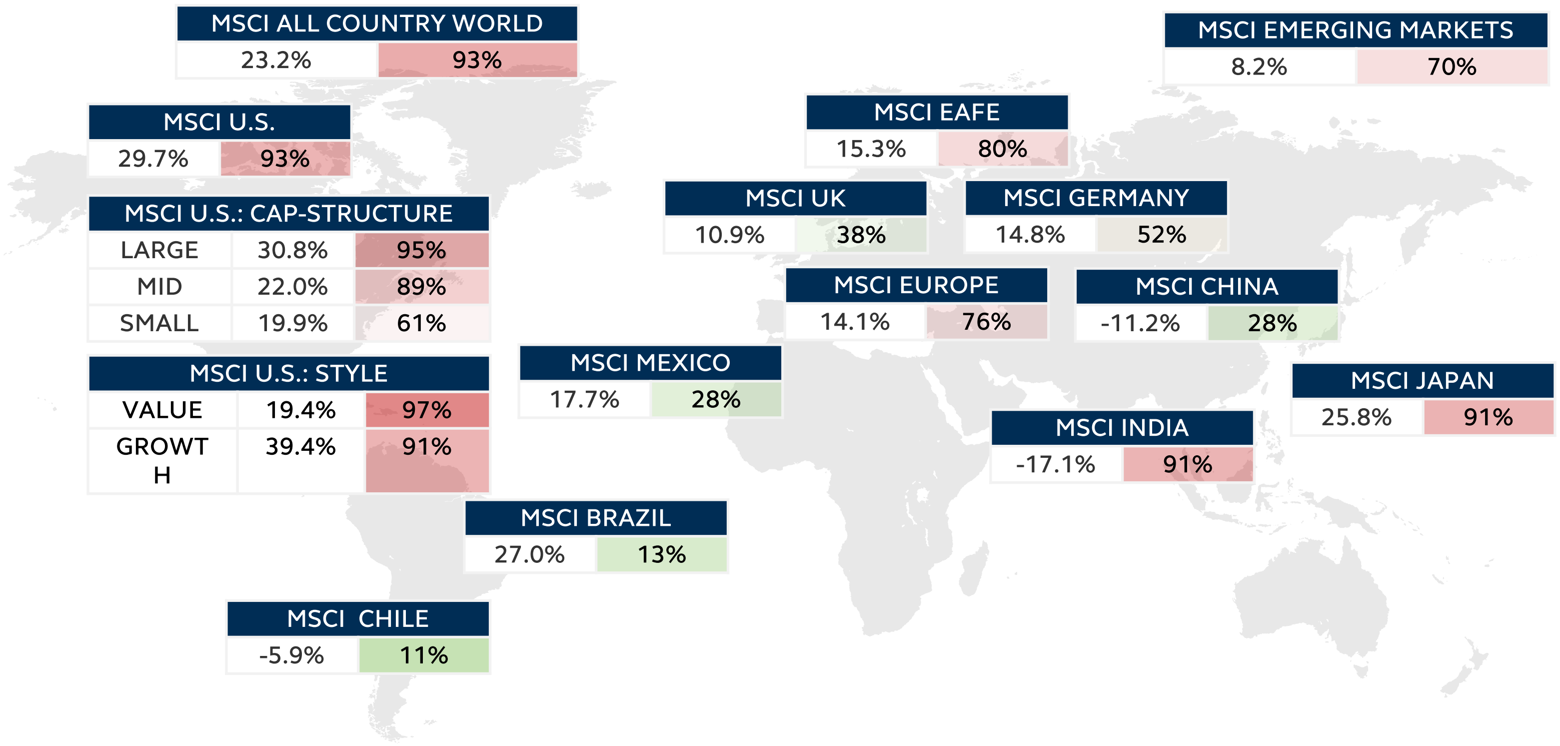
Global equity valuations: Pockets of opportunity

Although global valuations are stretched, there are pockets of opportunity that may be benefited 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: Federal Reserve, Bloomberg, Principal Asset Management. Data as of April 10, 2024.

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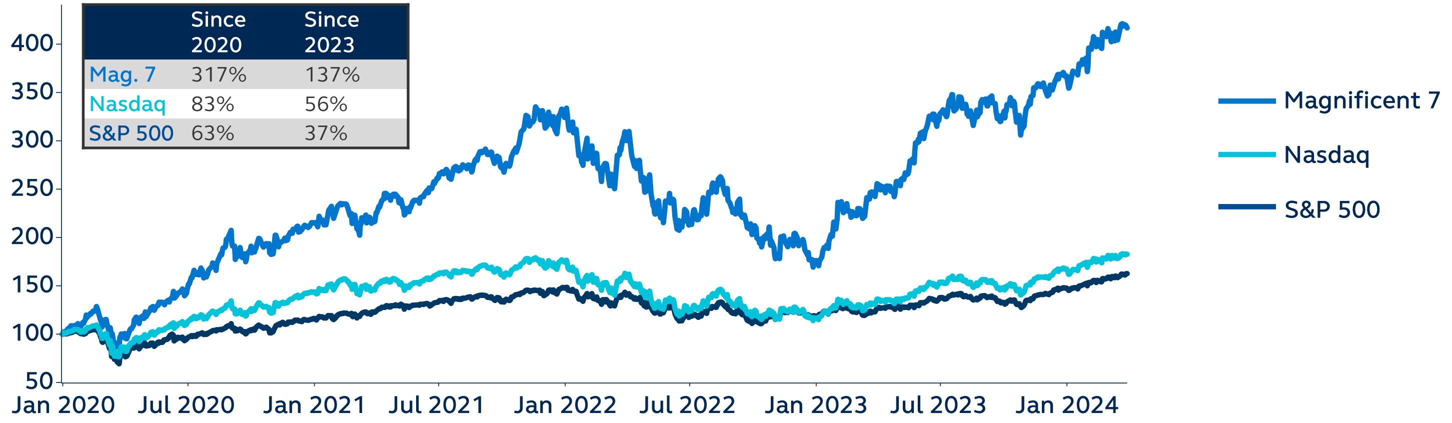
Equities: Our positioning shift to overweight

Magnificent 7 performance

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

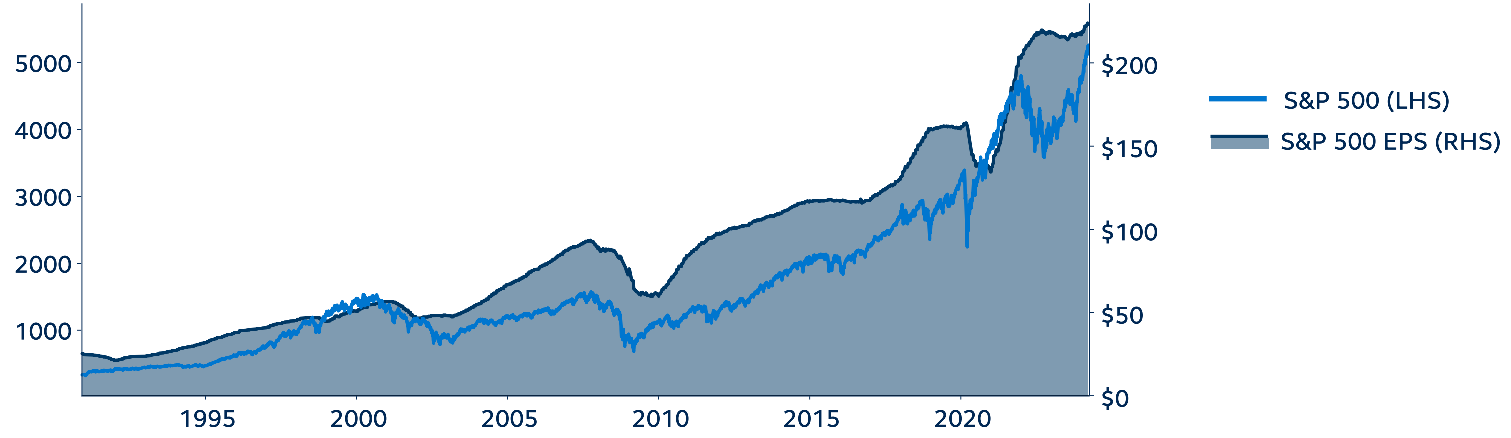


	Since 2020	Since 2023
Mag. 7	317%	137%
Nasdaq	83%	56%
S&P 500	63%	37%

**LTM=Last Twelve Month. Note: Pre-emptive and successful Fed cuts in moderate inflation includes periods when Fed cut and there was no recession, it also includes periods when recessions occurred due to unforeseeable incidents (COVID, spiking oil price etc.). Source: Bloomberg, Principal Asset Management. Data as of December 31, 2023.

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 March 31, 2024.

Central banks have fueled a market rally as they embrace optimism about inflation without sacrificing growth. Historically, when central bank easing takes place against a backdrop of a soft landing (like in 1995), the economy enters a mid-cycle position—whereby growth is stimulated by rate cuts, extending the economic expansion, the earnings upswing, and therefore, the market rally.

Yet, just like last year, the only investment decision that really mattered in 1Q was owning the Magnificent 7 stocks. They recorded a total return of 13.6% in 1Q. That follows on from an outstanding total return of 107% last year, accounting for most of the S&P 500 gains in 2023.

The Magnificent 7 might extend their positive performance. After all, the solid balance sheet characteristics and secure competitive market positions of the Magnificent 7 may imply that a significant correction is unlikely, despite their valuations drawing comparisons to the 2000s tech bubble. Yet, this year, the combination of a continued economic expansion, solid earnings growth and rate cuts might see strong performance broadening to other more cyclical sectors and markets whose valuations are not quite so stretched.

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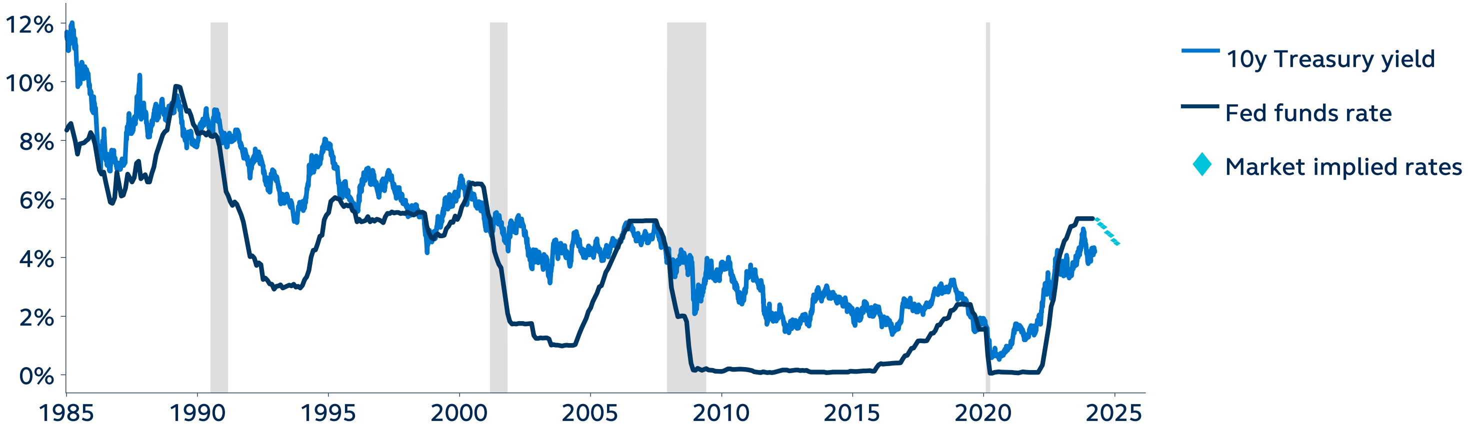
Fixed Income: Our positioning shift to overweight

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

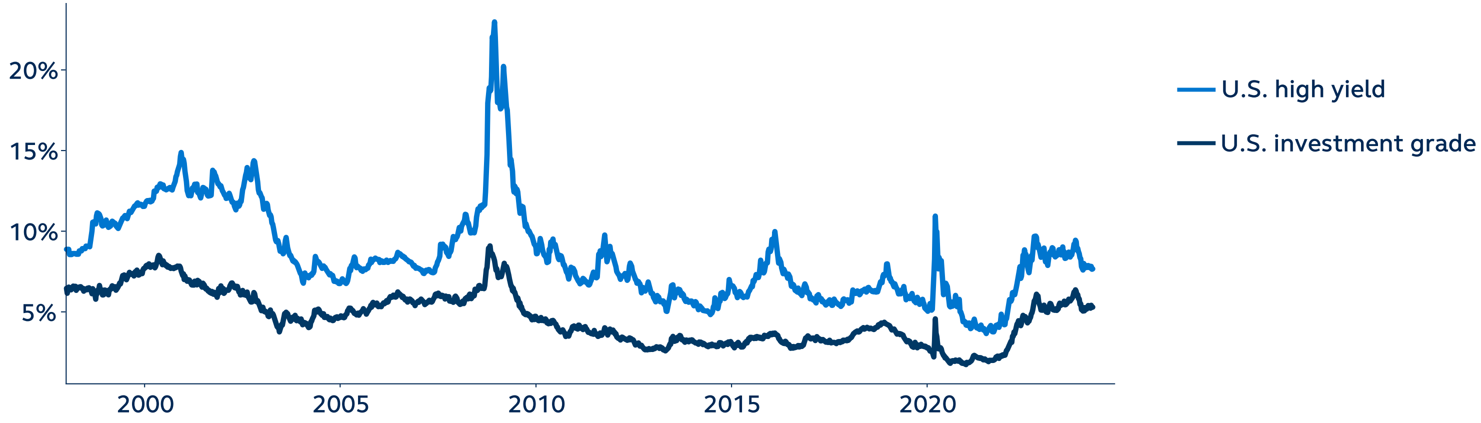
Recessions are shaded, 1985–present



Source: Clearnomics, Federal Reserve, Bloomberg, Principal Asset Management.
Data as of March 31, 2024.

U.S. high yield and investment grade spreads

Option-adjusted-spread, 1998–present



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

1Q was a challenging quarter for U.S. Treasurys as constructive economic data prompted markets to revise their Fed rate expectations path to a significantly less dovish one. U.S. Treasury yields corrected higher, albeit not quite to the highs of early 4Q 2023. With the Fed likely to start cutting rates later this year, Treasury yields could skew lower as investors look to lock in the current level of yields.

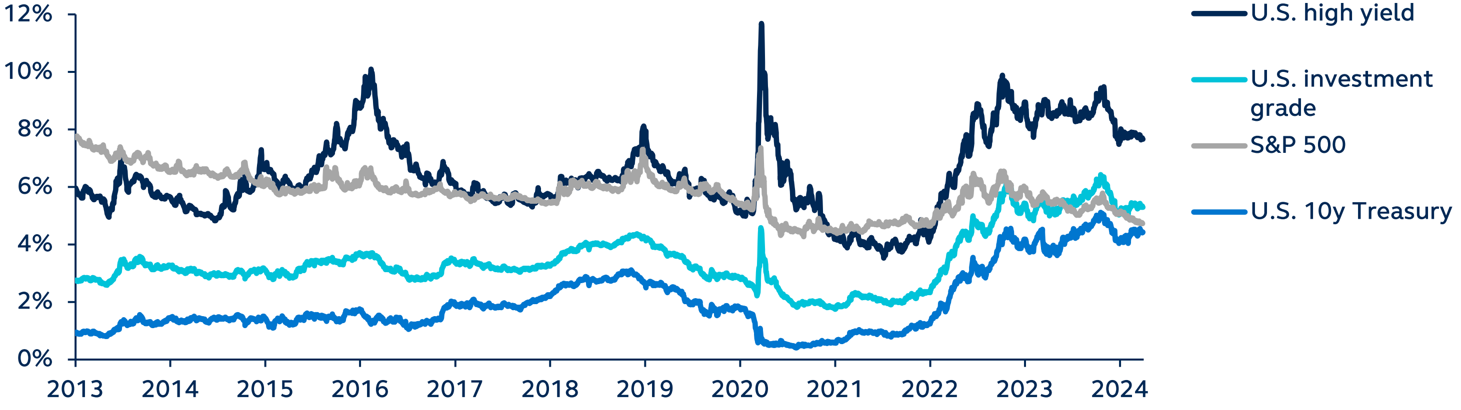
However, in the absence of a severe recession, Treasury yields are unlikely to revert to the ultra-low levels of recent years. With inflation set to remain above the 2% target for much of the forecast horizon, the Fed's easing cycle may be considerably more shallow than usual. In addition, shifting supply/demand dynamics in the Treasury space, particularly in an election year, may imply higher term premia.

By contrast, credit had a strong quarter, supported by the still strong economic backdrop. Credit spreads are at historically a tight level and in a soft landing scenario, might remain fairly tight. Note, though, that the prospect of a modest economic slowdown suggests limited room for further spread compression.

Fixed income: We're here for the carry

Yield comparison: High yield bonds, investment grade bonds, U.S. Treasurys, and S&P 500

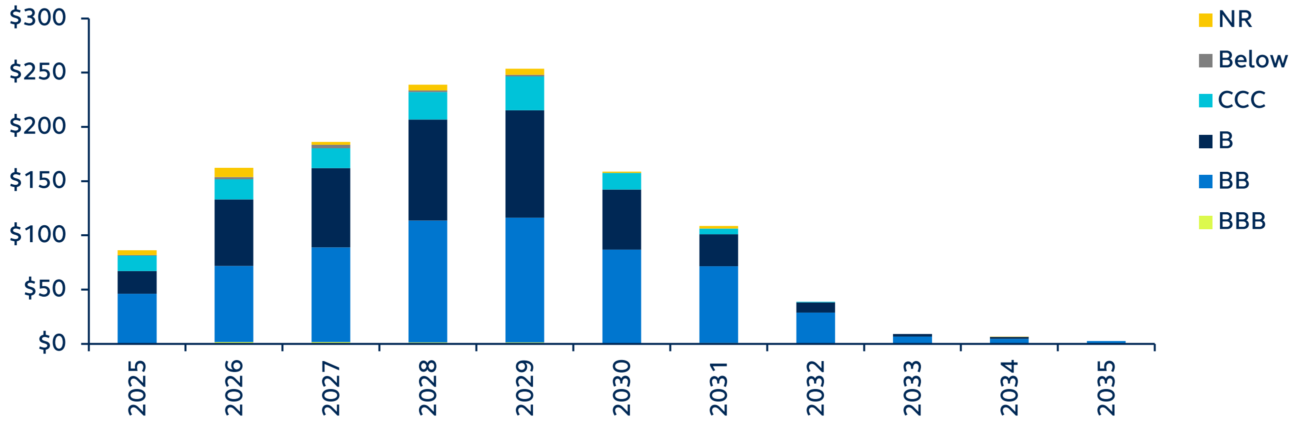
2013–present



High yield bond yield-to-worst, investment grade bond yield-to-worst, U.S. Treasury yield-to-worst, S&P 500 12m forward earnings yield Source: S&P Dow Jones, Federal Reserve, Bloomberg, Principal Asset Management. Data as of March 31, 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.

The combination of solid economic growth and a Federal Reserve that is clearly keen to cut policy rates has solidified a constructive backdrop for credit. Higher yields and lower interest rate volatility should continue to support strong institutional demand, while ETF inflows reflect healthy retail appetite.

Spreads are historically tight for both investment grade and high yield credit. Yet, while spreads may not tighten significantly from here, provided the economy does not deteriorate significantly, they should not widen much either. More pertinently, credit is offering important additional carry to U.S. Treasurys, while the total yield available in fixed income is also attractive compared to equities.

A much-flagged risk for high yield this year is that due to the Fed's 2022-23 hiking cycle, the wall of maturing debt face significantly higher refinancing costs, potentially triggering a spike in defaults. However, the resilient macro backdrop and strong balance sheets suggest that companies might scale the wall relatively unscathed. In addition, the maturity wall leans towards high-quality, suggesting that most companies may be able to digest the interest rate costs without too much strain.

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