Principal Hong Kong

4Q 2023 Market Outlook

Q4 2023 Global Asset Allocation Viewpoints – The last mile

Key themes

1. Global growth is facing a number of headwinds
The global outlook is being troubled by rising rates, oil prices and the U.S. dollar, resulting in investor risk aversion. The U.S. faces a consumer-led downturn, although corporate balance sheet strength should ensure it is only mild.

2. Inflation is decelerating, albeit slowly, and will likely end the year above target
Global inflation continues to recede, but deep economic slowdowns may be required to reach global central bank inflation targets. Higher oil prices, if sustained, also threaten to undermine anchored inflation expectations.

3.Global monetary tightening cycles are nearing the end, but rate cuts are not imminent.
As long as economic growth remains above trend, inflation may resurge, forcing continued caution amongst policymakers and delaying policy rate cuts.

4. Equities face limited upside as a 2024 soft landing is already priced in.
Spiking bond yields are challenging the equity market's soft landing assumption. With limited prospect of an upgrade to earnings expectations, equity market returns are likely to be muted—particularly until bond yields peak.

5. The global bond sell-off is disruptive but adds much-needed income to fixed income.
A nuanced approach is required in fixed income. Higher for longer may extend the bond sell-off, but a modest economic downturn means credit spreads can remain fairly tight. Bonds now may generate meaningful portfolio income.

6. Alternatives may provide important diversification against traditional equities and fixed income.
Until bond yields peak, REITs may remain under pressure. Commodities' strong performance may be sustained. While the less bearish economic outlook suggests infrastructure exposure is less crucial, inflation mitigation is still required.

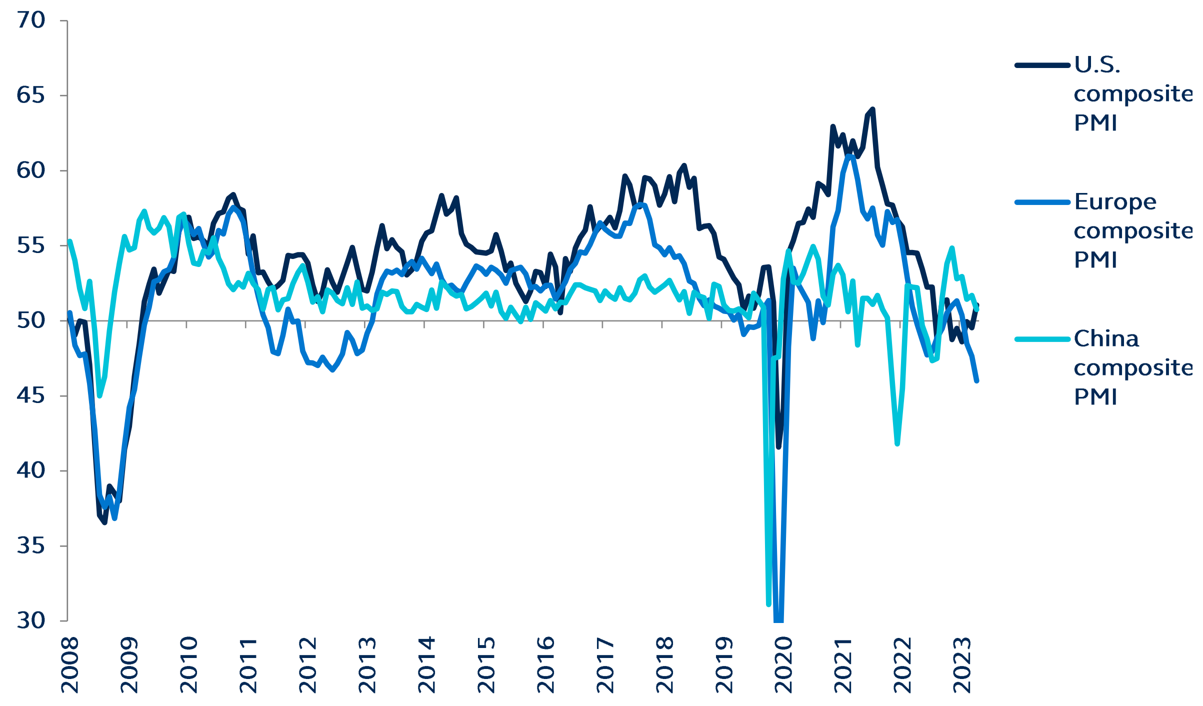
Asset allocation for Q4 2023	Investment preference Less << Neutral >> More				
Equities	○	◍ →	●	○	○
Fixed income	○	○	●	← ◍	○
Alternatives	○	○	●	○	○
Equities					
U.S.	○	◍ →	●	○	○
Large-cap	○	○	○	●	○
Mid-cap	○	○	●	○	○
Small-cap	○	●	○	○	○
Ex-U.S.	○	●	← ◍	○	○
Europe	○	●	← ◍	○	○
UK	○	●	○	○	○
Japan	○	○	○	●	○
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					
Infrastructure	○	○	●	← ◍	○
REITs	○	◍ →	●	○	○

Global economy: Starting to feel the heat

The global outlook looks troubled as rising rates, oil prices and the U.S. dollar may threaten to exacerbate economic slowdowns.

Developed market and China Purchasing Managers' Index (PMI)

May 2008–August 2023



Source: Bloomberg, Principal Asset Management. Data as of August 31, 2023.

U.S. 10-year Treasury yield, Brent crude oil price and U.S. dollar index

2019–present

Source: Federal Reserve, ICE Futures Europe, CME Group, Bloomberg, Principal Asset Management. Data as of September 30, 2023.

Inflation: In need of a little growth slowdown

Developed market central banks have made encouraging disinflation progress. Yet, the final shift lower toward central bank targets may require a meaningful economic slowdown.

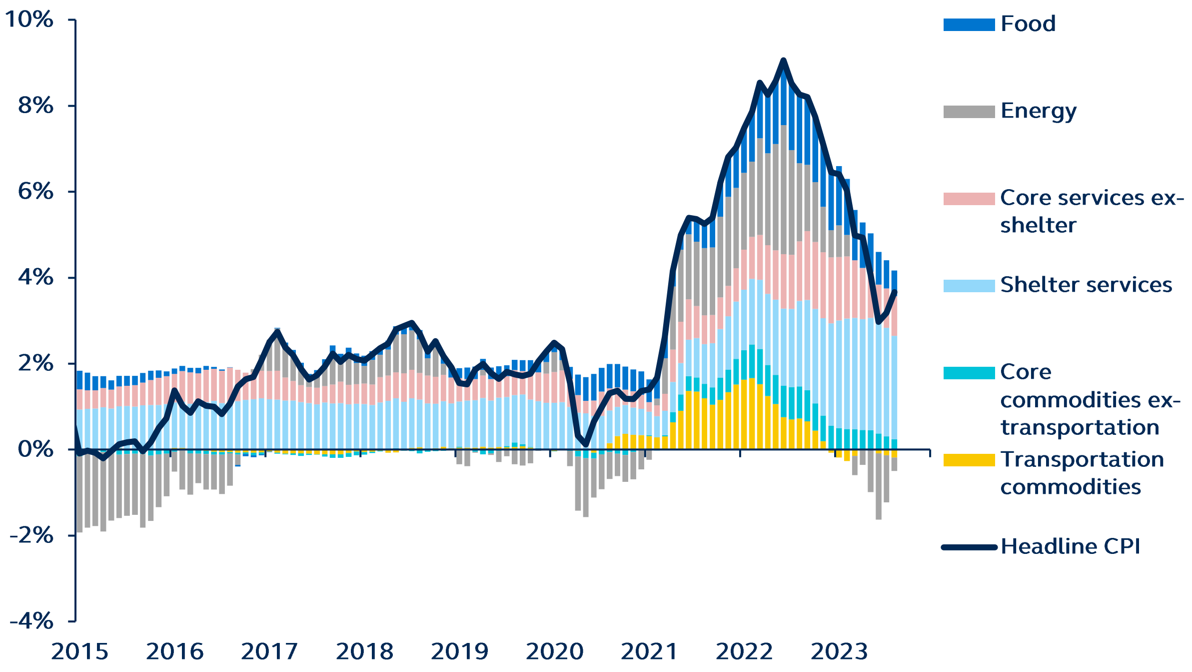
Principal Asset Allocation GDP-weighted inflation

January 2007–August 2023

Source: Bloomberg, Principal Asset Allocation. Data as of August 31, 2023.

Contribution to headline U.S. inflation

Year-over-year, January 2015–August 2023



Source: Bureau of Labor Statistics, Principal Asset Management. Data as of August 31, 2023.

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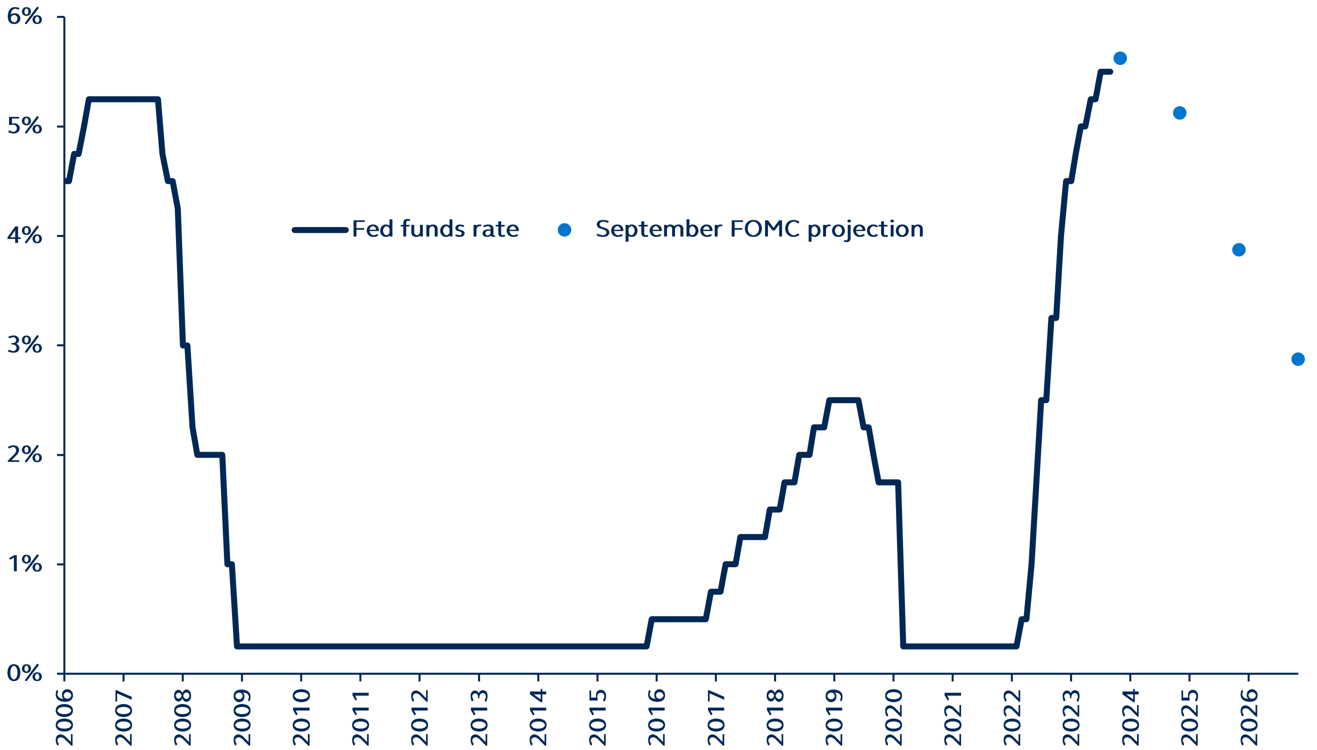
Central banks: Higher for longer

Fed policy rates have likely peaked, but rate cuts may not come until mid-2024 once the labor market shows evident signs of weakness.

Federal Reserve policy rates path

Fed funds rate and September FOMC forecast



Source: Federal Reserve, Bureau of Economic Analysis, Bloomberg, Principal Asset Management. Data as of September 30, 2023.

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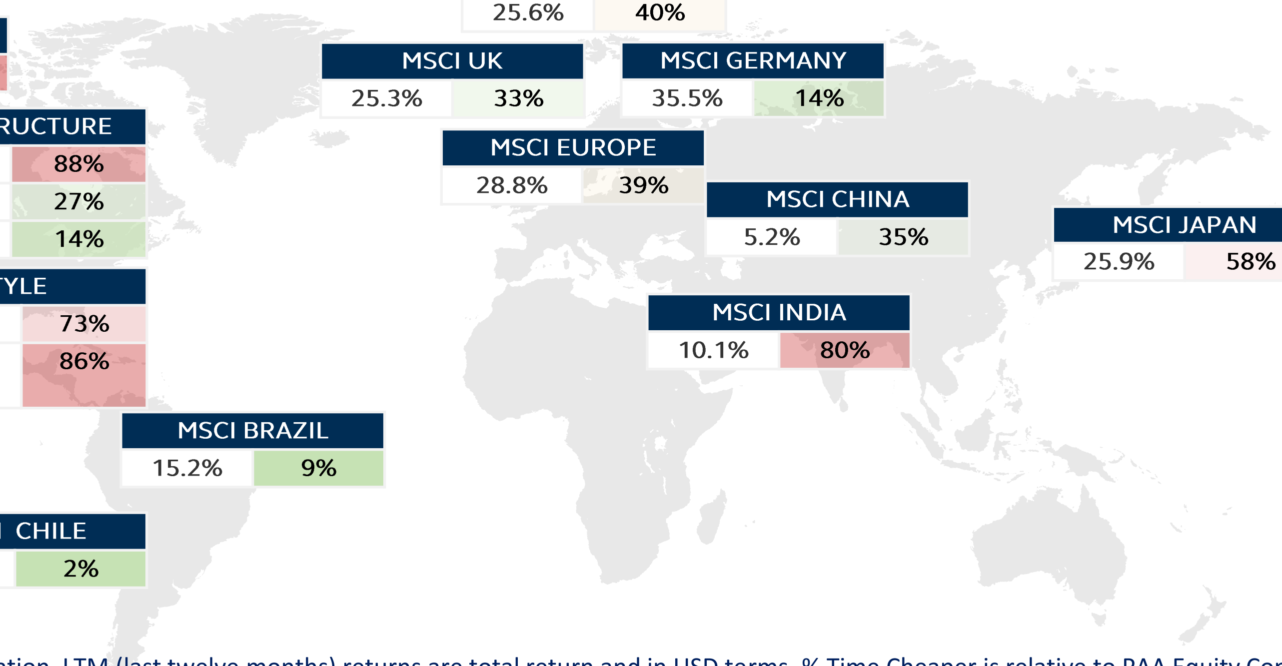
Global equity valuations remain stretched

Global equity retreated, but valuations remained stretched. The U.S. remains the most expensive market globally, while Latin America has rarely been cheaper.

Global equity returns and valuations

Last twelve months returns and % times cheaper, MSCI indices



INDEX	
(LTM)Last Twelve Month return (%)	% time cheaper

MSCI ALL COUNTRY WORLD	
20.8%	86%

MSCI USA	
21.0%	87%

MSCI USA: CAP-STRUCTURE		
LARGE	22.5%	88%
MID	11.1%	27%
SMALL	11.8%	14%

MSCI USA: STYLE		
VALUE	11.9%	73%
GROWTH	29.6%	86%

MSCI BRAZIL	
15.2%	9%

MSCI CHILE	
3.3%	2%

MSCI EAFE	
25.6%	40%

MSCI UK	
25.3%	33%

MSCI GERMANY	
35.5%	14%

MSCI EUROPE	
28.8%	39%

MSCI EMERGING MARKETS	
11.7%	46%

MSCI CHINA	
5.2%	35%

MSCI INDIA	
10.1%	80%

MSCI JAPAN	
25.9%	58%

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. Data as of September 30, 2023.

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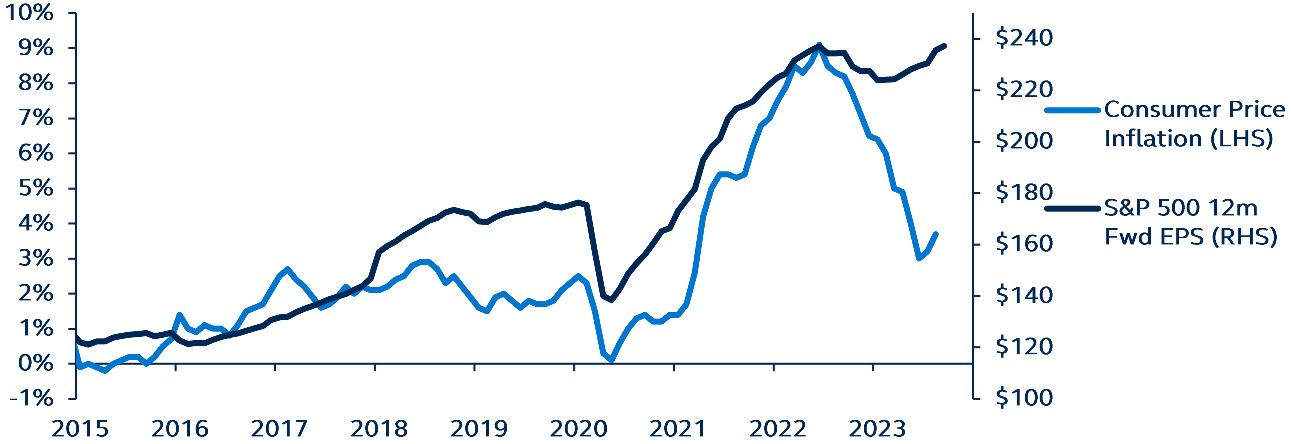
Equities: Our positioning shifts to neutral

Inflation and earnings estimates

2015–present



Source: Bureau of Labor Statistics, S&P Dow Jones, Bloomberg, Principal Asset Management.
Data as of September 30, 2023.

Cumulative foreign flows into Japan equities

Billions, 2012 – present

Source: Japan Ministry of Finance, Bloomberg, Principal Asset Management.
Data as of September 30, 2023.

- U.S. equities have already realized soft landing expectations. With the limited prospect of an upgrade to earnings expectations, equity market returns will likely be muted—particularly until bond yields peak. Once clear signs of earnings or economic slowdown emerge in late 2023 or even early 2024, equity markets may, at that point, come under renewed pressure.
- Broad defensives may deliver stronger performance. Energy stands to continue gaining from elevated oil prices. In addition, while higher bond yields are currently challenging tech companies, we retain a preference for large- over small-cap, given the increasing need for quality, large balance sheets and pricing power, as well as the secular AI trend.
- We increased our exposure to emerging markets to slightly overweight. Furthermore, Japan's economy has continued to strengthen, but without the high inflation and imbalances that have burdened other Developed market economies in recent years. Japan's desynchronization from other developed markets may provides an attractive opportunity for diversification.

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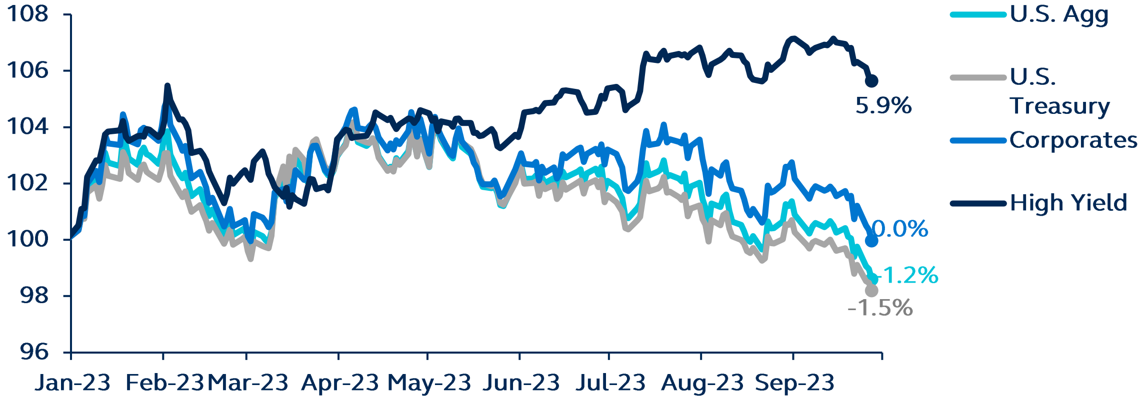
Fixed income: Our positioning shifts to neutral

Fixed income asset class performance

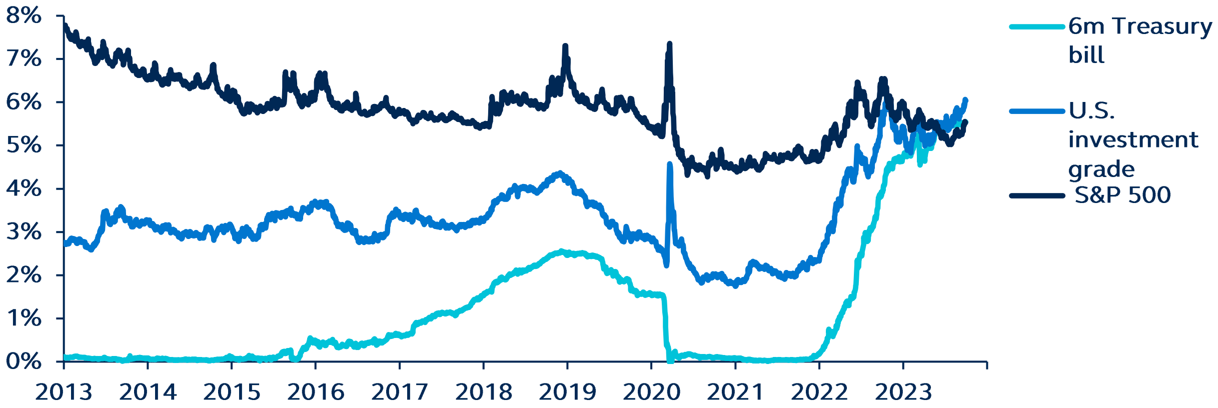
Total return, rebased to 100 at January 1, 2023



Source: Bloomberg, Principal Asset Management. U.S. Agg = Bloomberg U.S. Aggregate Bond Index; U.S. Treasury = Bloomberg U.S. Treasury Index; Corporates = Bloomberg U.S. Corporate Index; High Yield = Bloomberg U.S. Corporate High Yield Index. Data as of September 30, 2023.

Yield comparison: S&P 500, investment grade bonds, and 6-month Treasury bills

S&P 500 12m forward earnings yield, investment grade bond yield-to-worst, and 6-month Treasury bills yield



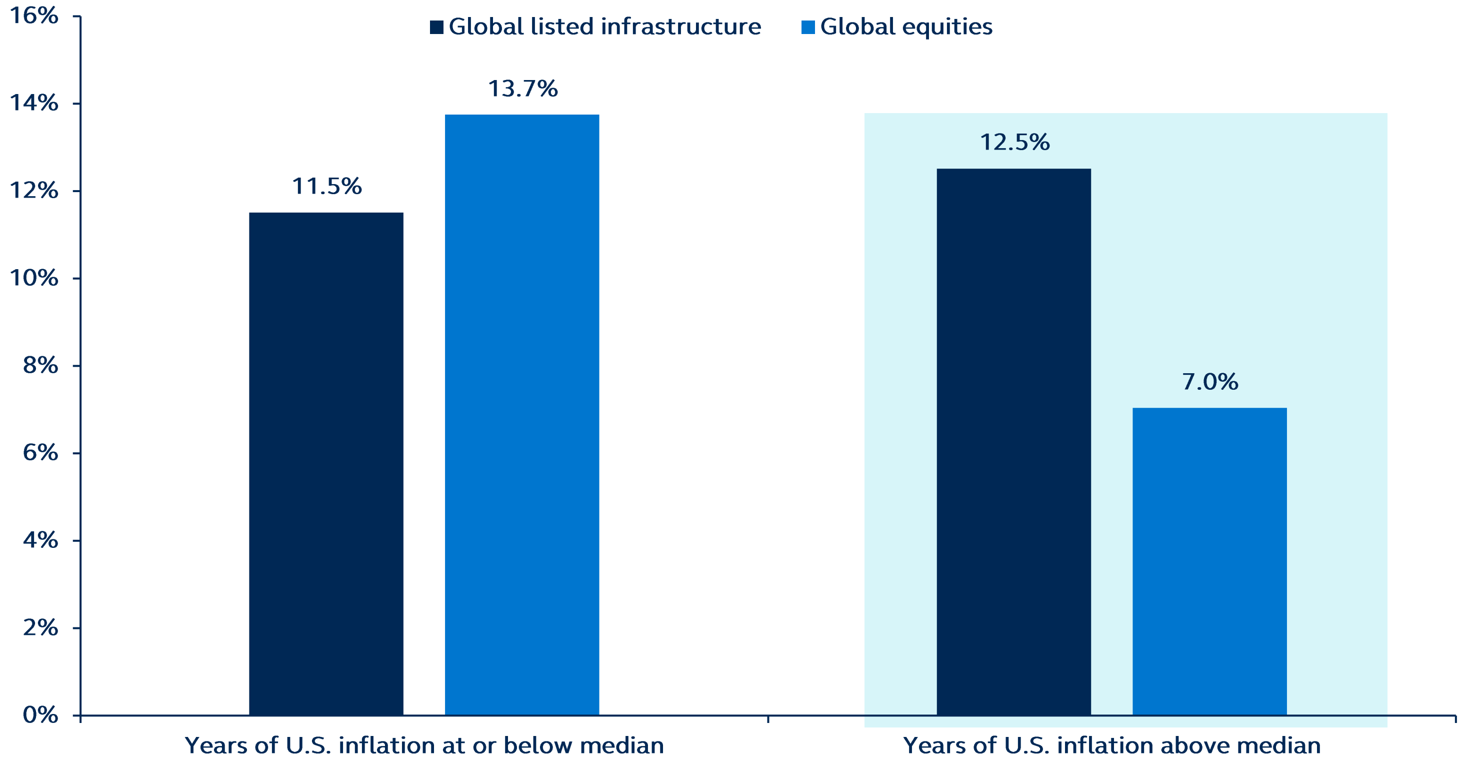
Note: U.S. investment grade represented by the Bloomberg U.S. Corporate TR Value Unhedged USD Index.
Source: S&P Dow Jones, Federal Reserve, Bloomberg, Principal Asset Management. Data as of September 30, 2023.

- Our fixed income positioning also shifts to neutral, mainly driven by our more cautious view on Treasurys. 10-year U.S. Treasury yields hit 4.57% at the end of Q3, the highest level since 2007. However, given the validity of the “higher for longer” narrative. Bond prices are not yet convincingly cheap.
- High-quality credit remains favorable ahead of the slowdown. Its Default risk should remain low and risk appetite robust, supporting current spread levels. While investment-grade remains at an overweight, high yield continues to sit at neutral.
- Local currency emerging market debt remains overweight as central bank rate cuts may enhance returns.

Infrastructure: Remain at a neutral weighting

Listed infrastructure versus global equities in differing inflation environments

2003–2022



Note: Global equities is represented by MSCI All Country World Index. Global listed Infrastructure is represented by the MSCI ACWI Utilities Index from 2003 through 2006, a 50/50 blend of MSCI ACWI Utilities Index and the Alerian MLP Index from 2007 through 2015, and the FTSE Global Core Infrastructure 50/50 Index thereafter. Past performance does not guarantee future results. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index.
Source: U.S. Bureau of Labor Statistics, CPI ex-food & energy, FactSet, Principal Asset Management. Data as of December 31, 2022.

- Infrastructure may not outperform global equities if the U.S. economy experiences a mild downturn and inflation continues to soften.
- Although an economic downturn is expected, it is projected to be only short and shallow. This less bearish economic outlook and its equity beta suggest that infrastructure may perform broadly in line with global equities, thereby deserving a neutral position. An inflation resurgence is a continued threat, and, as a result, infrastructure's inflation mitigation properties are still required in a portfolio.
- In addition, infrastructure investments can offer more stability within a well-diversified portfolio, typically having predictable cash flows associated with the long-lived assets. They also provide exposure to the global theme of de-carbonization, which presents a multi-decade tailwind for utilities and renewable infrastructure companies.

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