Principal Asset Management Company (Asia) Limited

2H 2022

Economic and Asset Allocation Outlook

Principal Q&As – Is the Worst Time Over?

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Can global economy achieve a "soft landing"? P.2

Will global inflation slow significantly? P.3

Can the Fed halt the pace of interest rate hikes this year? P.4

Will global equities rebound in the third quarter? P.6

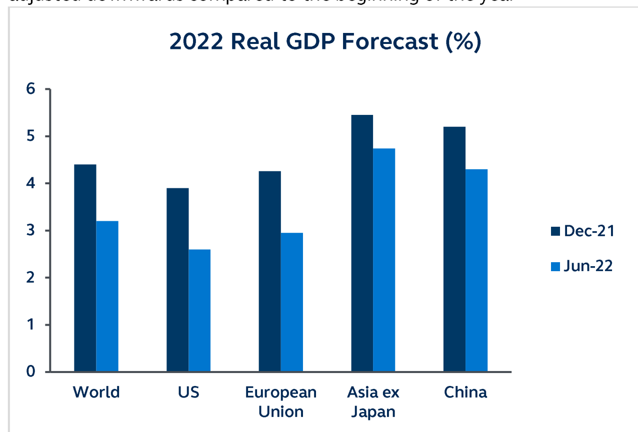
Will the yield curve stay inverted? P.9

Will the USD continue to rally? P.11

Can global economy achieve a "soft landing"?

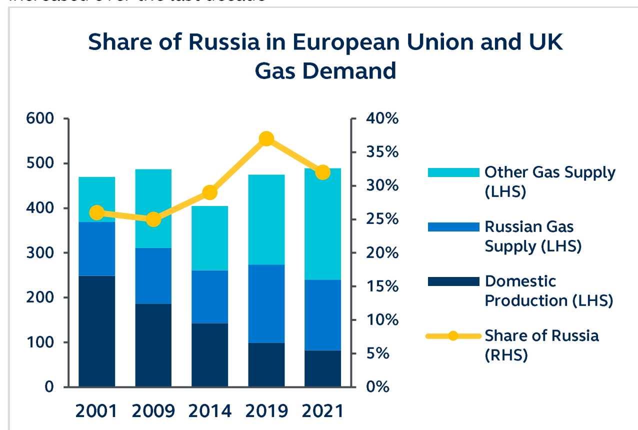
The U.S. economy may slow in the second half of the year, while the risk of recession in Europe is relatively high

Chart 1: Economic growth forecasts globally and in major economies were adjusted downwards compared to the beginning of the year



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 15, 2022.

Chart 2: The reliance of the Europe and UK on Russian energy supplies has increased over the last decade



Source: IEA, Principal Asset Management Company (Asia) Limited. Data as of December 31, 2021.

Year-to-date, continued geopolitical tensions, China's lockdowns, rising inflation and global central banks tightening have led to downward revisions to economic growth forecasts globally and in major economies (Chart 1). With supply bottlenecks persist, high inflation denting consumer confidence, and tighter financial conditions, the global economy may continue to slow in the coming months. However, with China stepping up its easing and additional European stimulus to fund defense spending, that should offset some of the downward pressure. The global growth rate may settle at about 3% in 2022.

For the U.S., our view on the overall economy is gloomier than at the beginning of the year. Supported by relatively high levels of savings, consumer demand and business investment, the U.S. economy may be more resilient than the other developed markets. However, being dragged by high inflation and rapidly rising interest rates, its economic growth rate may slow to below the long-term trend in the second half of the year, with full-year growth rate decelerating to below 3%. As the effects of monetary tightening emerge after 6 to 24 months, recession risks may rise sharply in the second half of next year or in early 2024.

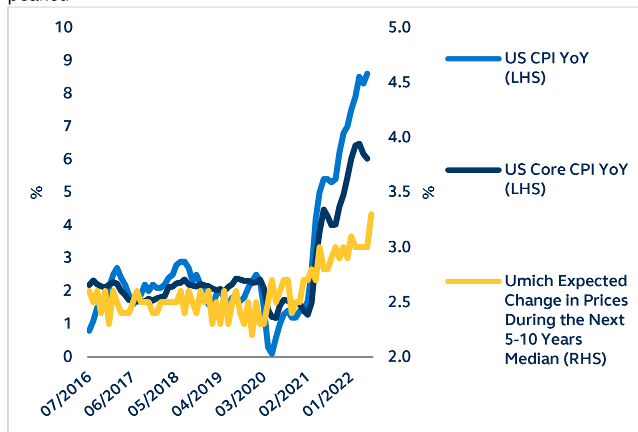
Among major economies, we are more pessimistic on Europe because of the connections it has with Russia (Chart 2). EU may ban 90% of Russian oil imports by year-end. With CPI hitting a new-high in May, it would be unavoidable for ECB to take on a more aggressive tightening path from July onwards, hiking consecutively in the policy meetings in the 2H. The era of negative interest rates may end in September. If the Russia-Ukraine conflict continues to drag on, the negative shock on Eurozone's growth could exceed 1.5 points, with growth rate slowing to about 2%. The risk of stagflation is rising rapidly. A recession in the region before the end of the year is not impossible.

Relatively speaking, economic conditions in Asia may be comparatively stable. Even in the face of Russian-Ukrainian tensions and the downward pressure on China's economy, Asia's full-year real economic growth forecast has been revised down to a relatively small extent, and the full-year growth rate may still reach 5%. Even though it is still affected by rising oil prices, inflation in the region is somewhat controlled, and the urgency of policy tightening is not as high. In addition, in some of the countries within the region, such as ASEAN, economic and tourism activities have rebounded significantly after the pandemic, supporting the overall economy.

Will global inflation slow significantly?

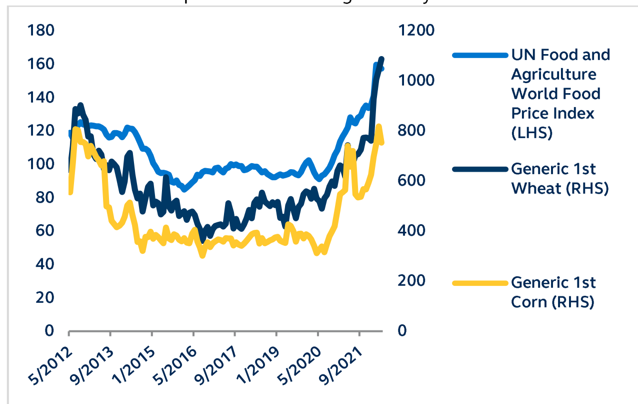
U.S. inflation may drop slightly to about 6% by year-end as oil and food prices are expected to stay high

Chart 3: The U.S. consumer prices and inflation expectations have not peaked



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 15, 2022.

Chart 4: Global food prices have risen significantly



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 15, 2022.

Driven by the continued rise in oil and food prices, global inflation remains high, albeit at a slower pace, especially in developed markets. The U.S. consumer price index (CPI) rose 8.6% year-on-year in May, hitting a new 40-year high. It destroyed market expectations for a short-term peak in U.S. inflation (Chart 3).

In the coming months, as geopolitical tensions continue and Chinese demand recovers, commodity and food prices may continue to add upward pressure on U.S. and global inflation, driven by supply shortages. On the oil price front, Russia's crude oil production has been declining due to sanctions. Therefore, even OPEC+ verbally indicated an increase in production by 50%, the actual implementation is doubtful. Before the end of the Russian-Ukrainian conflict, with the gap between supply and demand in the oil market likely to persist, the average price of crude oil is likely to stay above $100 - $110 in the second half of the year.

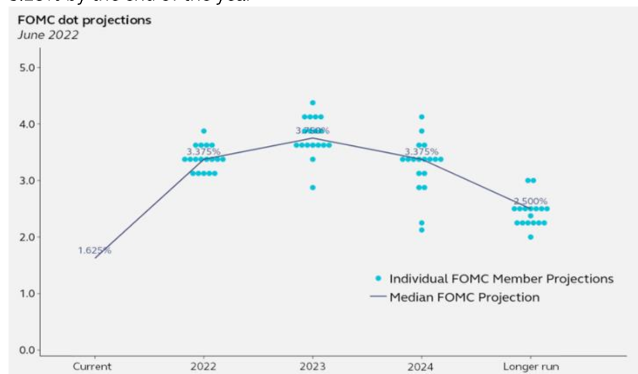
This is true for food prices as well. Supply disruptions caused by geopolitical disputes have led to rapid increases in agricultural prices as Russia and Ukraine together account for almost a third of global wheat exports and around a fifth of global corn exports. In addition, energy itself is an important input cost for agricultural production processes, such as heavy machinery, fertilizers, and transportation. Rising energy prices have pushed up global food prices. Even though there is a chance that food prices will fall due to high inventories in the coming months, they will remain high by the standards of the past few years due to shortages in supply and high oil prices (Chart 4).

Observing the composition of the US CPI data, it is found that, rising prices in the stickier parts of the market, such as shelter, has not peaked. These factors suggest that the decline in inflation—whenever it finally comes—will be extremely slow. Before the end of the year, the US CPI may only fall slightly to the level of about 6%. With the gradual adjustment of demand, inflation may fall to a greater extent in 2023 and return to the level of about 3% by the end of next year.

Can the Fed halt the pace of interest rate hikes this year?

Fed fund rate may rise to 3.25% by year-end, and this rate hike cycle may end by mid-2023

Chart 5: The Fed's dot plot indicates the Fed fund rate may be higher than 3.25% by the end of the year



Source: The Federal Reserve, Clearnomics, Principal Global Asset Allocation, Principal Asset Management Company (Asia) Limited. Data as of June 15, 2022.

Chart 6: The Fed has cut economic growth projections for next few years

Percent

Variable	Median[1]			
	2022	2023	2024	Longer run
Change in real GDP	1.7	1.7	1.9	1.8
March projection	2.8	2.2	2.0	1.8
Unemployment rate	3.7	3.9	4.1	4.0
March projection	3.5	3.5	3.6	4.0
PCE inflation	5.2	2.6	2.2	2.0
March projection	4.3	2.7	2.3	2.0
Core PCE inflation[4]	4.3	2.7	2.3	
March projection	4.1	2.6	2.3	
Memo: Projected appropriate policy path				
Federal funds rate	3.4	3.8	3.4	2.5
March projection	1.9	2.8	2.8	2.4

Source: The Federal Reserve, Principal Asset Management Company (Asia) Limited. Data as of June 15, 2022.

Even in the face of slowing economic data, the Federal Reserve decided to raise interest rates by 75 basis points in June, the steepest hike since 1994. This reflects Fed's concerns about high inflation and further rising inflation expectations. At the next meeting, it is not impossible to raise rates by 75 basis points (bps). However, given that core inflation has begun to slow down and part of the economy, such as retail sales and housing markets, have begun to weaken, we tend to believe that there is a greater chance to hike by 50bps in July.

Assuming another 50bps at the September FOMC meeting and the Fed will then begin to slow down the pace of interest rate hikes, there will be two more 25 bps hike at the remaining two meetings this year. Fed fund rate may at least climb to 3.25% by the end of the year. In the first half of 2023, depending on the economic data at that time, the Fed may raise rates two to three times. The benchmark rate may peak at 4% in the middle of next year, and the rate hike cycle may come to an end (Chart 5). In this scenario of a successful "soft landing" of the economy, the U.S. economic growth rate may return to its long-term trend, inflation fall significantly, and unemployment rate rises slightly, policy rates may be lowered again by the end of next year (Chart 6).

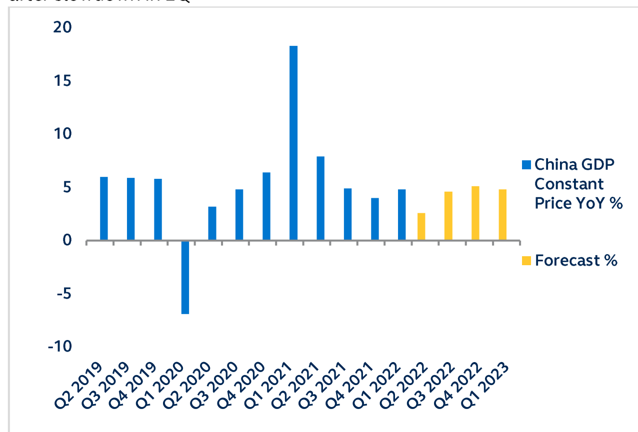
However, in our downside scenario where inflation stays high throughout, the Fed may not be able to slow down the pace of rate hikes before the end of the year. Coupled with a global economic slowdown and significant market volatility, eroding consumer and business confidence, the downside risks of the U.S. economy may surge rapidly. The time for a significant increase in the probability of a recession may be pushed forward to the beginning of next year. The Fed may end its rate hike cycle before year-end and start cutting interest rates again as soon as early next year. Besides raising rates, the Fed has commenced shrinking its balance sheet, referred to as QT, on June 1. The initial scale would be $47.5 billion per month ($30 billion in U.S. Treasuries and $17.5 billion in mortgage-backed securities). It will be doubled to $95 billion per month after three months ($60 billion in U.S. Treasuries and $35 billion in mortgage-backed securities). At this rate, by the end of 2022, the size of the balance sheet will be reduced by about $500 billion. The effect will be equivalent to a 25bps hike.

If the US economy manages to hold up, the entire balance sheet reduction may last two to three years until the end of 2024. Even if the Fed may adjust the size of reduction while economic conditions deteriorate, the size of the balance sheet may eventually fall to around US$6.5 trillion to 7 trillion. That may continue to push up real yields and Treasury term premium, making equities less attractive.

Can China meet the 5.5% full-year growth target?

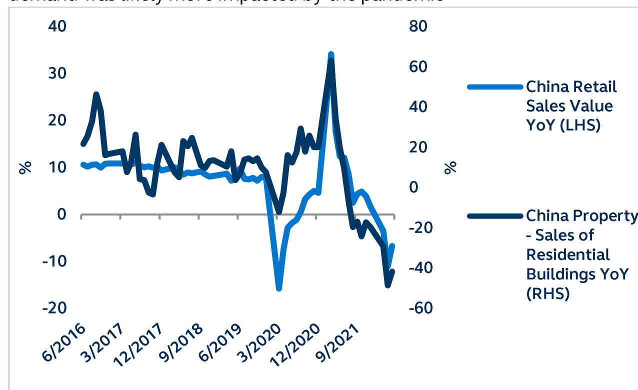
The economy is expected to improve in the second half of the year, while the resurgence of the pandemic remains as a structural risk

Chart 7: The Chinese economy may rebound in the second half of the year after slowdown in 2Q



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 15, 2022.

Chart 8: China retail and real estate sales recovered slowly as the domestic demand was likely more impacted by the pandemic



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of May 31, 2022.

Affected by the spike in new COVID cases and the partial lockdowns in different cities, the Chinese economy was quite weak entering the second quarter. The overall economic growth rate in the second quarter may slow quite dramatically compared with the first quarter. With the introduction of measures to stabilize growth introduced one after another, the economy may rebound in the second half of the year, with the economic growth rate reaching 4.5% to 5% in 2022. China may not be able to achieve the annual growth target (Chart 7).

As a matter of fact, economic data had begun to improve. In May, China's manufacturing PMI rebounded from a 26-month low to 49.6, ending the decline of the past two months. Although the slide in retail sales continued, the decline was significantly narrowed to -6.7% compared with April. Industrial output rose 0.7% from a year ago, reversing the falling trend in April. These data suggest that the worst time for the economy may be over, but the recovery process will take quite a while.

The impact of the latest round of the pandemic on the economy is similar to that in the past. The impact on supply is relatively small, but that on domestic demand is more profound. Even though total retail sales rebounded in May on a monthly basis, there was still some distance from the peak compared to earlier this year. Real estate development and sales remained weak (Chart 8). Both retail and construction are highly labor-intensive industries, so the unemployment rate fell only marginally to 5.9%, above the annual target of 5.5%.

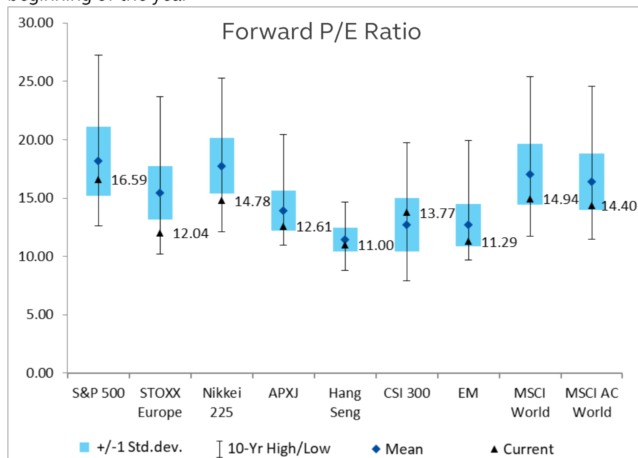
At the same time, in the face of the risk of a resurgence of COVID cases, as long as China's "zero-COVID" policy remains in place, the economic growth rate may be impacted negatively again. Even if a prolonged city-wide lockdown can be avoided, the zero-COVID policy represents that mass testing and local lockdown measures may become the norm, limiting consumer activities and spending to a certain extent. Coupled with weakening external demand, the recovery will be relatively slow.

Therefore, the central government may continue to accelerate the intensity of economic stimulus measures. It can be seen from the recently announced "33 Measures to Stabilize the Economy" that the mainland tends to continue to expand support for medium, small, and micro enterprises, individuals and industries severely affected by the epidemic. Policies include tax rebates, financial support and rent reduction. Given the sharp rise in foreign interest rates and the trend of the RMB exchange rate, the People's Bank of China may not cut interest rates again in this economic cycle. Compared with traditional monetary policy, the central government may continue to focus on fiscal policy tools or supportive policies for individual industries, especially the real estate sector, to stabilize economic development.

Will global equities rebound in the third quarter?

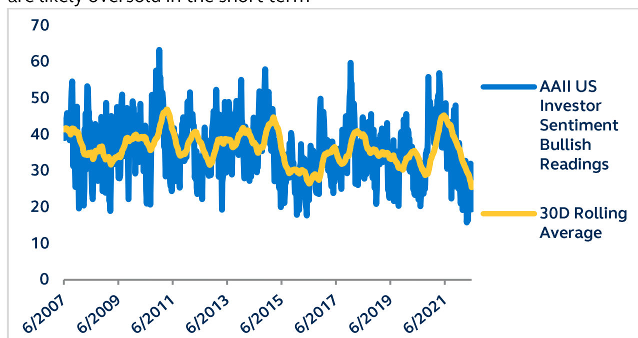
Remain a neutral stance on equities overall, which may fall again after a bear market rebound

Chart 9: Global equities valuations have cheapened compared to the beginning of the year



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 15, 2022.

Chart 10: The sentiment of retail investors is relatively negative. Equities are likely oversold in the short term



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 16, 2022.

Stocks were plagued by risk-off sentiment throughout 1H22. Geopolitical factors related to the conflict between Russia and Ukraine intensified supply chain issues, causing a surge in oil and food prices. With the world facing greater inflationary pressures, there were further tightening of monetary policy by global central banks. Coupled with China's zero-COVID strategy deterring the economy, global equities slipped further in the second quarter. US stocks lagged behind and officially entered bear market territory. Value investments outperformed, while Europe and Japan dropped by a lesser extent among developed markets. Energy was the best-performing primary sector as it led IT stocks by approximately 50% over the past year.

Fundamentally, equity valuations have undoubtedly cheapened this year. No matter comparing with the first quarter/ late last year, global equity valuations had came down closer to fair value. Measured by forward price-to-earnings ratios, valuations in most markets have retreated to below their 10-year averages. Regionally, US remained the most expensive. European and Japanese stocks are more than one standard deviation below their 10-year averages. Asia and Hong Kong are close to one standard deviation below their 10-year averages as well (Chart 9).

Earnings expectations held up quite well so far. MSCI AC World's expected EPS growth for 2022 ticked up to 6% as 1Q earnings season delivered positive surprises in aggregate. However, with global economy on the downside and inflation elevated, EPS revisions may stay negative.

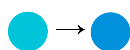
From the start of the year to the end of May, funds inflow by institutional investors into equities amounted to USD178 billion, only about 20% of the total amount in 2021. Retail investors' investment sentiment remains relatively negative, with the American Association of Individual Investors (AAII) Investor Sentiment Survey showing that the proportion of optimistic US investors fell to a thirty-year low in April (Chart 10). After markets have fallen for some time, extreme sell-offs and relatively reasonable fundamentals may trigger a bear market rebound. However, should economic data deteriorate rapidly and recession worries spike, stocks may pull back significantly again.

We are neutral on stocks in the third quarter overall. Compared with most developed markets, Asia's inflation outlook is relatively benign. As some countries in the region do not need to hike rates urgently, and can also benefit from rejuvenation of economic activity after the pandemic, Asia can be viewed more favorably.

Will value investments continue to lead?

More constructive on Asia, Japan and Hong Kong. Allocate to value and defensive sectors

Q3 Outlook	Underweight	Slightly Underweight	Neutral	Slightly Overweight	Overweight
Equities	○	○	●	○	○
- US	○	○	●	○	○
- Eurozone	○	●	○	○	○
- Asia ex-Japan	○	○	● (previous quarter)	●	○
- Japan	○	○	○	●	○
- HK	○	○	● (previous quarter)	●	○
- China	○	○	●	○	○
- Other EMs	○	●	○	○	○



indicates a change in preference from the previous quarter

U.S. – As fiscal support is set to generally decline in 2022 and 2023, tighter monetary policy by the Fed to stabilize price in times of high inflation may exert further pressure on economic growth, and even lead to an early recession. Valuation of US equities is not attractive compared to other global major markets. However, S&P 500 companies have increased the pace of share buybacks as market declines depress stock prices. The amount is expected to hit a record this year, which may boost earnings per share.

Eurozone - Given supply chain tensions and direct impact from the reduction in Russian oil supply, Eurozone inflation pressures may not be quickly eroded in the future. The European Central Bank may have to deliver its first rate hike in more than a decade and further normalization is expected. The era of monetary policy normalization will come and financial conditions in the region will likely tighten. With this higher inflation and lower growth outlook, the Euro area is the key developed market economy facing prominent stagflation risk. At the same time, as tensions between Russia and Ukraine continue, earnings expectations are likely to face more pressure amid falling PMIs with increasing costs.

Asia ex-Japan - Asia in general has limited direct trade links to Russia and Ukraine. The spillover effects will be limited to the commodity price channel and to indirect impacts via weaker demand from key trading partners. Despite higher inflationary pressure caused by sharp increase in food and energy price, Asian central banks likely tighten at a less aggressive pace compared to developed countries with limited wage increase and currency depreciation. Also, the reopening of ASEAN countries accelerates, while China continues to introduce measures to stabilize economy, which may lead to the pickup of the domestic economy and the recovery of trades.

Japan – Faced with relatively weak economy and controlled inflation, the Bank of Japan will likely remain the only major central bank to maintain ultra-loose monetary policy. Japan's government has tweaked the wording around its balanced budget commitment to gain more fiscal flexibility to shore up its economic recovery. Valuation of Japan equities is relatively attractive. The current backdrop of elevated inflation and major central banks tightening are supportive for value investing like Japanese equities. With the spread between US and Japan government bonds continues to widen, the Yen remains weak. It may be favourable to Japan equity if increased export revenue supported by Yen depreciation could outpace the amount of additional import price cost due to higher inflation.

Hong Kong and China – As the central government further implements economic stimulus measures, and

individual cities such as Shanghai reopens, China's economy is expected to be better in the second half of the year than the first half. Fiscal and monetary policies remain accommodative. With investors sentiment improves, it may benefit HK and China equities. Relatively speaking, Hong Kong equities become more attractive based on PB at historical lows and A/H Shares Premium above 10-year average. There may be greater upside potential for Chinese stocks listed in Hong Kong.

Other emerging markets – Generally speaking, expectations of monetary policy tightening across the world, along with the pressure of a rising Greenback, will cause greater tightening pressure on financial conditions of emerging markets and capital outflow. In February this year, financial conditions of emerging markets had already fallen into contraction range. The outlook of emerging markets is mixed. Expected economic growth in emerging European markets is relatively weak this year due to the situation in Ukraine and rising oil prices, etc. For some Middle Eastern oil exporters, however, an increase in oil prices could offset the downward pressure on their economies which were hitherto facing tight financial conditions, decreased income from tourism and weaker demand.

Sector allocation – Earnings growth of the energy sector is positive. Due to the shortage in supply, imbalance between supply and demand in oil markets is likely to persist, and high oil prices may keep benefitting the energy sector. During rate hike cycles, value investment trends should continue. Higher rates could increase the net interest income and net interest margin of the financial sector, which could benefit related industries. Meanwhile, healthcare is another sector that deserves attention. Besides large companies that offer high dividends and better defensive characteristics, there is also an abundance of innovative medical companies with higher growth potential. Visible demand growth of the entire sector should be able to fend off market uncertainties.

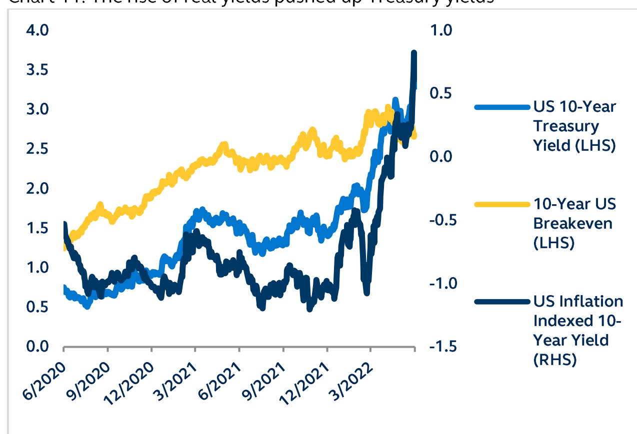
Will the yield curve stay inverted?

Spread between three-month and ten-year Treasuries may invert by the end of the year. Retain a neutral stance for bonds overall

Q3 Outlook	Underweight	Slightly Underweight	Neutral	Slightly Overweight	Overweight
Fixed Income	○	○	●	○	○
- Sovereign	○	● (previous quarter)	●	○	○
- Investment Grade	○	○	●	○	○
- High Yield	○	○	●	○	○

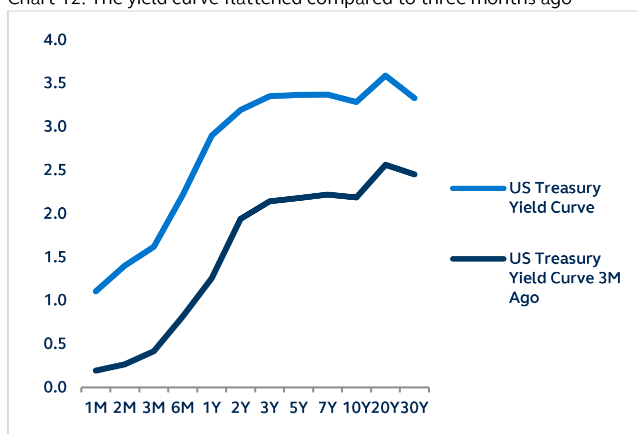
● → ● indicates a change in preference from the previous quarter

Chart 11: The rise of real yields pushed up Treasury yields



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 15, 2022.

Chart 12: The yield curve flattened compared to three months ago



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 15, 2022.

US Treasury yields rose across the board this year. Ten-year yield surpassed 3.4% at one point, the highest level since 2011. Taking a closer look at the change in ten-year yield, increase in real rates accounted for over 90% of the overall rise, demonstrating greater market expectations for policy tightening by the Fed (Chart 11).

As the yields of short-term Treasuries surged, the US yield curve became partially inverted for the second time this year. Markets were concerned about the spread between two-year and ten-year Treasuries, which was briefly inverted again in May. Nonetheless, it is noteworthy that the spread between three-month and ten-year Treasuries, a better indicator of the relationship between short-term funding costs and long-term returns, grew wider compared with the start of the year, currently sitting at over 160 bps (Chart 12).

Historically, the Treasury yield curve has inverted before every U.S. recession. However, a credible recession signal needs to last for a period of time and reach a certain depth. Since 1977, after the last eight inversions of the two-year and 10-year Treasury yield curves, the three-month and 10-year Treasury yield curves have subsequently inverted on five occasions. Almost every time after the inversion between three-month and 10-year, the investment market would peak and fall; Economic recessions would occur, with an average time lag of about 14 months.

Leveraging the model from New York Fed, which uses the slope of yield curve to calculate the probability a recession in the US twelve months ahead, has indicated that recession probability has been consistently falling, which deviates a more pessimistic picture from the recession concerns that market participants have. In

our view, as the Fed continues to raise interest rates significantly towards the middle to end of the rate hike cycle, the concerns of recession risk may rise substantially and the inversion of the three-month and 10-year spreads may occur before the end of the year.

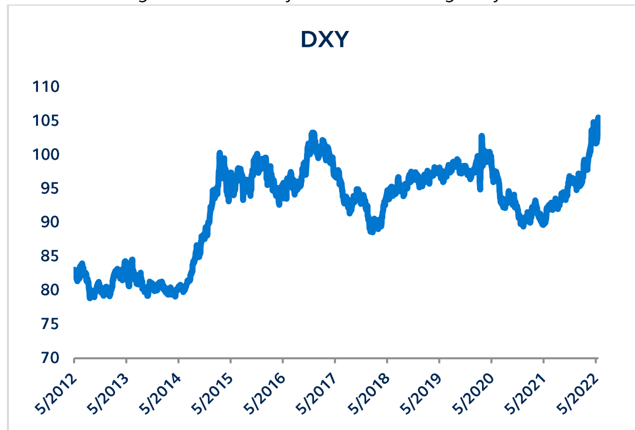
While real interest rates may peak and retract later this year due to worsening economic conditions, high inflation and tight labor markets may inhibit the Fed from decelerating the pace of policy tightening in the short term. Real interest rates and overall yield in the third quarter may remain elevated. We remain a neutral stance on sovereign bonds in the third quarter.

With rising yields pressuring corporate bonds, total return of investment grade bonds may continue to face headwinds. The credit spread of high yield bonds, which is more correlated with economic development, expanded substantially, while the yield of global high yield bonds rose past 8%, on par with pre-pandemic levels in 2020. Despite this, since the fundamentals of corporate bonds remain solid, default rate of high yield bonds is expected to stay at the 1.5% level for the next 12 months, far lower than the historical average of 4%. Moreover, valuations have returned to reasonable levels, we remain our neutral stance on investment grade and high yield bonds.

Will the USD continue to rally?

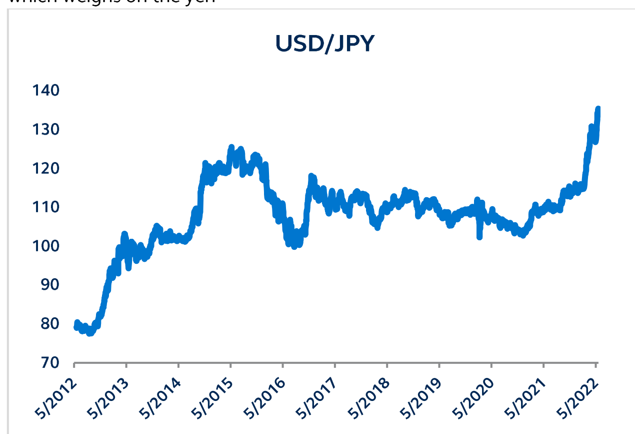
US Dollar Index may reach 108, while EUR/USD exchange rate may sink to 1

Chart 13: Strong dollar trend may not reverse during the year



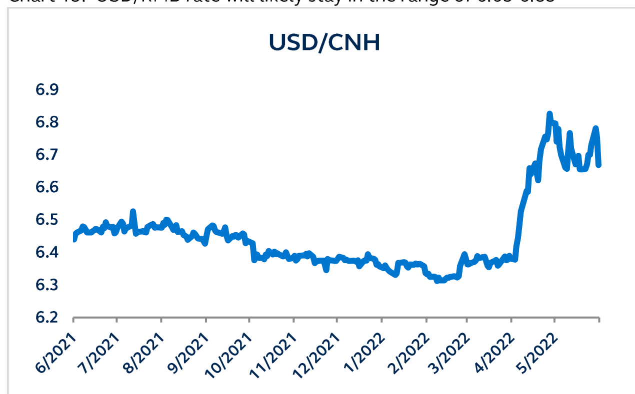
Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 15, 2022.

Chart 14: Japan's central bank maintains ultra-loose monetary policy, which weighs on the yen



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 15, 2022.

Chart 15: USD/RMB rate will likely stay in the range of 6.65-6.85



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 15, 2022.

Geopolitical risk arising from the Russia-Ukraine conflict, compounded with monetary policy tightening by the Fed have triggered risk-off sentiment across markets this year thus far. The USD continued to rally and the US Dollar Index surged passed 105, a 20-year high. Despite real effective exchange rates indicating that USD valuation has risen from the start of the year, solid fundamentals may continue to prop up the Greenback throughout this year.

While some central banks in developed markets may continue or begin to hike rates, the divergence between monetary policy implemented by the Fed and other major central banks may widen, especially relative to Japan and China, and higher rates may cause the USD to continue to benefit from carry trades. The global economy is in a downward cycle and financial conditions may return to contraction territory shortly. US economy is relatively solid and risk-off sentiment is strong. These factors may continue to push the USD higher, with the US Dollar index likely to reach 108 by the end of the year (Chart 13).

The JPY/USD rate fell by 17% this year, to the lowest point since 1998. Ultra-accommodative monetary policies maintained by the Bank of Japan (BOJ) put the Yen under pressure. Data of the US Commodity Futures Trading Commission (CFTC) revealed that JPY short positions rose to levels unseen in over three years. The JPY may still face depreciation pressure due to a lackluster economy, but continued depreciation of the currency has already become a cause for concern for the BOJ. The Bank may raise the tolerated limit of ten-year Japanese government bonds, alleviating the urgency to continuously purchase these bonds as well as the downward pressure on the Yen. The USD/JPY rate may fluctuate in the range of 130-140 in the third quarter (Chart 14).

Looking at the Euro, the ECB may tighten the monetary policy more aggressively with inflation hitting record highs. Nonetheless, with the Eurozone economy under pressure, markets may lower rate hike expectations, limiting the EUR's upward space. With the ECB reducing market liquidity, rates in Eurozone peripheries surged, resulting in greater funding costs for companies in the region, which could trigger market concerns over local debt issues. The EUR/USD rate thus remains

under downward pressure and may fall to 1 EUR for 1 USD by year-end.

For the RMB, because of the pandemic, softening of the economy in China, as well as diverging monetary policies in China and the US causing the invert in US-China government bond spread, the USD/CNH rate broke through 6.8 for the first time since September 2020. For the third quarter, the US government is considering removal of tariffs on some Chinese goods, which should improve China-US trade relations, and the Chinese economy may rebound in 2022 second half. Nevertheless, US rate hikes will still exert depreciation pressure on the RMB, and the USD/RMB rate will likely stay in the range of 6.65-6.85 (Chart 15).

DISCLOSURES

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