

Principal Asset Management  
Company (Asia) Limited  
**2H 2021**  
Economic and  
Asset Allocation Outlook



## Principal Q&As – Navigating Through The Noise



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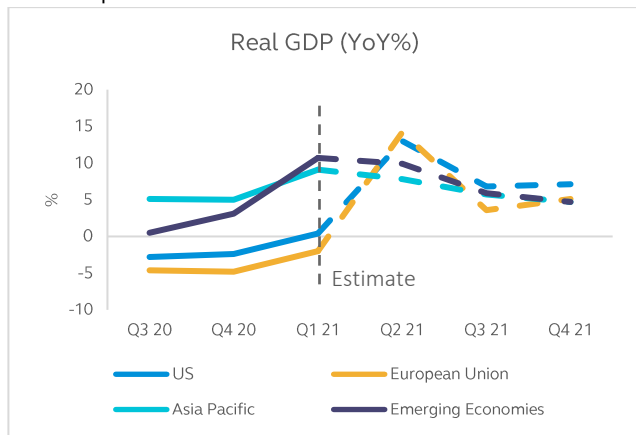
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# Can global economic growth be sustained?

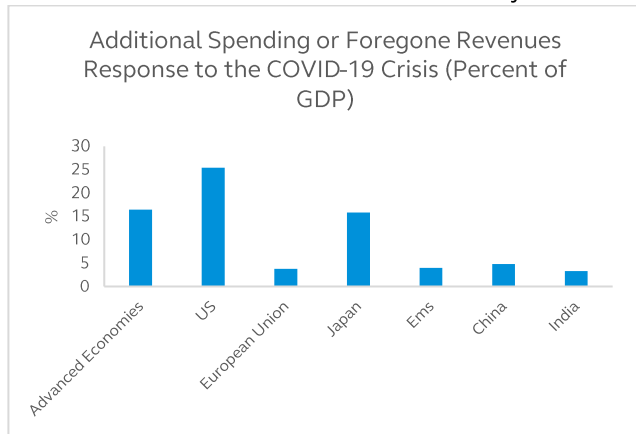
The economic growth rate in some developed markets is likely to have peaked in the second quarter, while the overall economic growth trend is expected to remain unchanged.

Figure 1: The economic growth rate in many developed markets around the world is likely to have peaked in the second quarter



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

Figure 2: The scale of fiscal measures that the United States has introduced is far ahead of other major markets



Source: IMF, Principal Asset Management Company (Asia) Limited. Data as of April, 2021.

Since the beginning of this year, with extremely accommodative global financial conditions coupled with fiscal stimulus measures and the steadily improving number and rate of global vaccinations, the global economy continues to recover from last year's COVID-19 pandemic. Economic activities are returning to pre-pandemic levels, whilst global economic growth for this year has the opportunity to reach a remarkable 6%, which may mark the fastest growth rate since 1973. However, with the low base effect of the same period last year gradually receding in the second half of the year, the economic growth rate in many developed markets around the world is likely to have peaked in the second quarter (Figure 1). Nonetheless, the overall economic growth trend is expected to remain unchanged with the support of numerous positive factors.

Among these, the United States is the global growth engine, with its GDP expected to surpass pre-epidemic levels by 2021. Since the outbreak of the COVID-19 pandemic, the scale of fiscal measures that the United States has introduced is equivalent to 25% of its 2020 GDP, far ahead of other countries (Figure 2). There are still aspirations for more fiscal stimulus measures in the future, including a US\$1 trillion infrastructure plan. Looking ahead to the second half of the year, the fiscal transfers triggered by multiple fiscal stimulus measures have significantly increased the current savings rate of the American people compared to the pre-pandemic period, spurring potential consumption power in goods and services. Consumer spending, which accounts for about two-thirds of economic output, may provide further growth momentum to the US economy.

In Europe, the pandemic has gradually been brought under control through accelerated vaccinations. While many countries have lifted restrictions, the eurozone economy quickly recovered in the second quarter. The Manufacturing Purchasing Managers' Index (PMI)

maintained a record high of 63.1 in June. Unfulfilled orders, employment growth, etc., maintained growth, whilst business sentiment has been simultaneously strengthened. Although the scale of fiscal stimulus is relatively weak under the constraints of the EU system, the European Central Bank will maintain an accommodative monetary stimulus policy for some time in the future. The current emergency bond purchases are expected to be maintained at the current pace before March next year. The economic outlook remains positive.

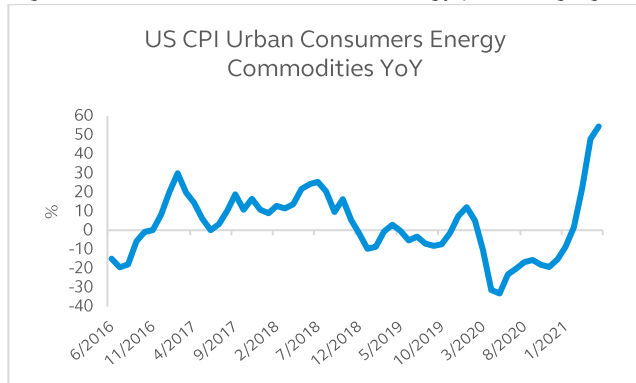
In Asia, with the accelerated pace of vaccinations in the region, the increase of newly diagnosed cases has temporarily slowed down. The rapid economic recovery in China and India may lead to a significant economic rebound in emerging Asian markets. With the economic recovery of developed markets and increasing import demand, the spillover effect from growth is likely to benefit industrial exports from India, China, and Vietnam. At the same time, the recovery of domestic demand in the region is also likely to boost economic performance.

Other emerging market economies are facing greater downside risks. Since last year, the overall upward trend in commodity prices has benefited commodity-exporting countries such as Chile, Russia, and Brazil. However, the ensuing inflationary pressures have also forced the central banks of Turkey, Russia, and Brazil to raise interest rates to control price levels, which has significantly tightened local financial conditions. Compared with the capability of developed markets to support their economies by increasing government spending, low-income emerging market countries face the problem of insufficient fiscal policy space. Since the outbreak of the COVID-19 pandemic, the overall scale of fiscal measures introduced by emerging markets accounts for only 4% of GDP, which has slowed the domestic economic recovery in the regions. Should developed markets gradually tighten monetary policy in the future, the escalated market interest rates may weaken the repayment ability of highly indebted countries. A stronger US dollar may cause capital to flow out of emerging markets. At the same time, due to the relatively unstable vaccine supply, emerging markets are still facing the risk of a rebound of infections caused by COVID-19 variants.

# Is the rise in inflation temporary?

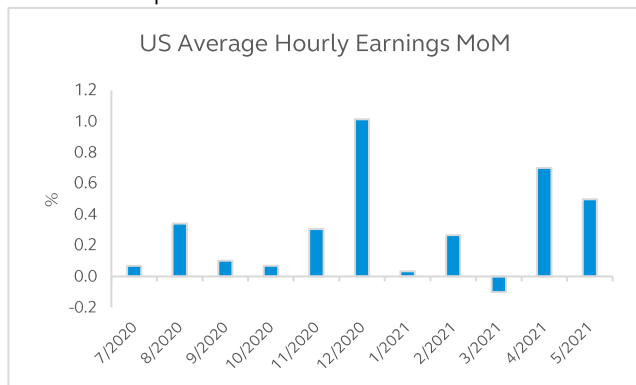
The recent rise in inflation may be dominated by transitory factors, but there are upside risks to it.

Figure 3: The low base resulted in energy price surging



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

Figure 4: The US average hourly wages have increased more than expected month-on-month



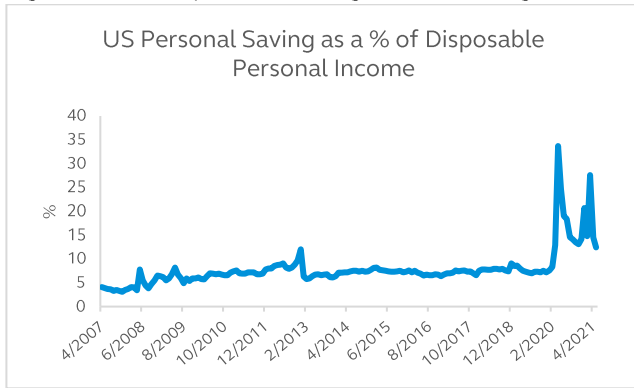
Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

The global economy has rebooted this year following the impact of COVID-19 in 2020. Commodity prices surged significantly, stimulating global inflation. In May, the US consumer price index (CPI) increased by 5% year-on-year (YOY), and the eurozone CPI increased by 2% YOY. Inflationary pressures in some emerging markets were even greater. Owing to short-term consumption driven by the lifting of restrictions which is expected to continue for some time, coupled with the ongoing supply shortage, Principal’s forward-looking indicators reveal that the US and global inflation may remain high in the third quarter, and gradually decelerate in the fourth quarter.

A careful analysis of the US inflation data shows that the sharp rise in CPI in May was mainly due to rising prices of energy, second-hand cars, and clothing. Among these, energy prices plummeted to a negative level last year, and the low base resulted in the consumers energy CPI index surging 54.5% YOY in May (Figure 3). On the other hand, the rupture in the global supply chain forced auto manufacturers to stop production, resulting in a surge in pre-owned car and truck prices. The hike in clothing prices was related to the release of backlog demand after the global economy reopens. However, regardless of whether it is a low base effect, supply chain bottlenecks, or retaliatory consumption, these short-term factors are believed to be unsustainable. The rise in inflation is temporarily dominated by transitory factors.

However, inflation risks are to the upside. The current total employed population in the United States has recovered only 60% compared with before the pandemic. Yet, the US average hourly wages have increased more than expected month-on-month (MOM) over the past two months, suggesting that employers are still hiring at higher costs even as the job market is still facing a large

Figure 5: The US personal savings rate is at a high level



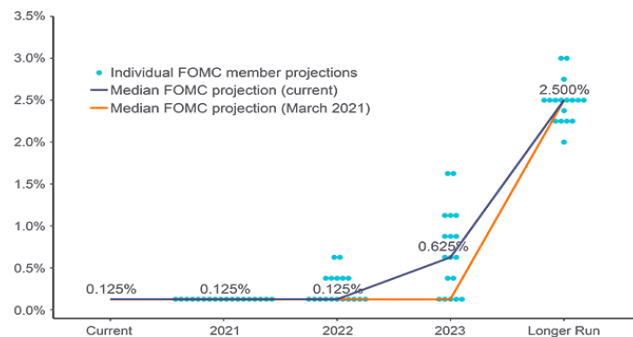
Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

gap. It is highlighted that there may be a mismatch between the supply and demand of job functions (Figure 4). If wages continue to climb, there is an opportunity to push up the overall price levels. On the other hand, the current US personal savings rate is at a high level of 14.9% (Figure 5). If consumption picks up further in the second half of the year, and the pace of supply adjustment continues to fail to catch up, inflation may be higher than originally expected and last longer.

# Will monetary policy remain accommodative?

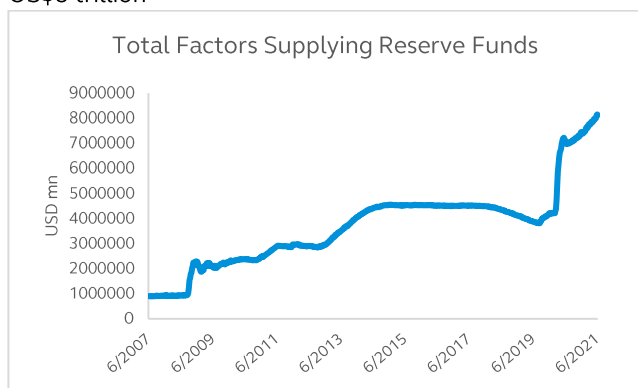
## The United States may scale back bond purchases by year-end, while global financial conditions are expected to remain accommodative overall.

Figure 6: The Fed suggested that there is a possibility of raising the policy rate twice by the end of 2023



Source: The Federal Reserve, Clearnomics, Principal Global Investors, Principal Asset Management Company (Asia) Limited. Data as of June 16, 2021.

Figure 7: The scale of Fed's balance sheet has exceeded US\$8 trillion



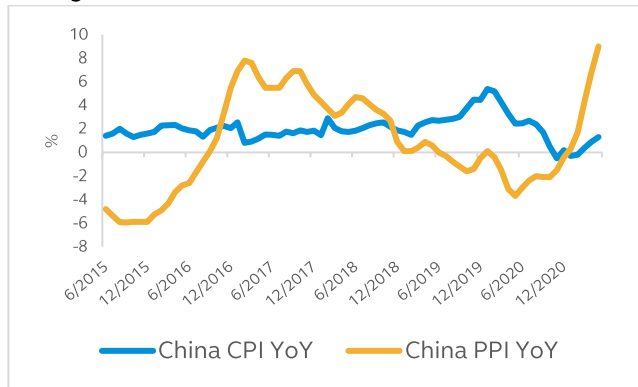
Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

The US Federal Reserve (Fed) conveyed a hawkish message during the June interest rate meeting by raising its forecast on inflation, suggesting that there is a possibility of raising the policy rate twice by the end of 2023 (Figure 6), and that the Fed will start discussions on reducing bond purchases. We believe that Fed Chairman Jerome Powell has the opportunity to make clear that the Fed intends to tighten policies during the Jackson Hole meeting in August and that the plan will be officially launched before the end of the year or early next year, depending on the progress of economic recovery.

The current scale of Fed's balance sheet has exceeded US\$8 trillion (Figure 7), which is significantly higher than the US\$4.5 trillion following QE3. Therefore, the impact on the balance sheet and even market liquidity will be relatively limited even if the Fed starts to reduce bond purchases. Secondly, it may take about one year to complete the entire plan, which means the Fed's balance sheet will still be in a state of expansion in 2022. As for interest rate hikes, as it may take at least about two years for the local job market to return to pre-pandemic levels, we expect the Fed to raise interest rates not earlier than the second half of 2023.

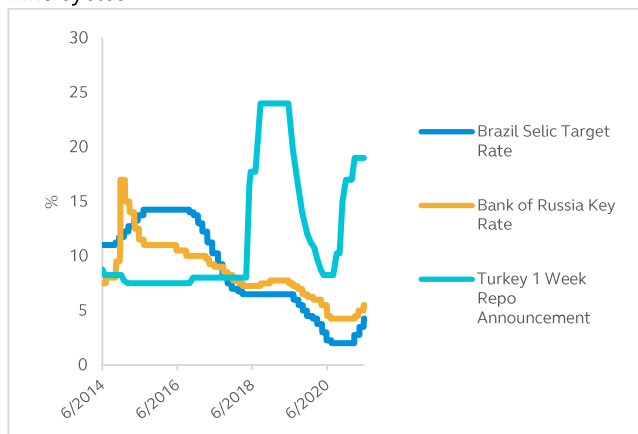
Among the other developed markets, the Bank of Canada has the opportunity to increase interest rates in early 2023 should the job market fully recover. According to the current economic and inflation situation, the UK's timetable may be similar to that of the US. Compared to the other developed markets, primary inflation pressures in the eurozone and Japan remain relatively under control. The policy direction is expected to sustain the momentum of the economic recovery, especially in Japan, which is still facing the pandemic.

Figure 8: China production prices may remain high in the short term, while consumer prices may be relatively manageable overall



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

Figure 9: Some emerging markets have begun interest rate hike cycles



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

As for emerging markets, fundamental differences exist among Asia, Latin America, and Europe, the Middle East, and Africa (EMEA). With reference to China, the largest economy in Asia, although production prices may remain high in the short term. Due to the plunge in pork prices and relatively weak demand, the costs that can be transferred to consumers are relatively limited. Consumer prices may be relatively manageable overall (Figure 8). Hence, there is no urgency for the People's Bank of China (PBOC) to adjust interest rates. The PBOC may support the economy and prevent risks of an economic bubble by adjusting liquidity. As for the Reserve Bank of India, it is very likely to maintain an accommodative monetary policy by purchasing bonds to support the economic recovery from the pandemic.

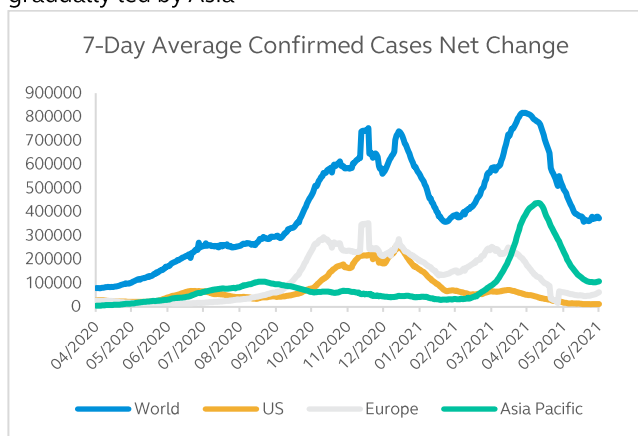
On the other hand, emerging markets countries (including Brazil and Russia) have begun to raise interest rates to curb escalating inflationary pressures (Figure 9). Driven by the sharp increase in demand for agricultural products, anticipation for inflation continues to rise. The Central Bank of Brazil is expected to take every action to curb inflation, and policy rates will continue to increase significantly in the future. Some EMEA countries are also facing similar situations. In the face of a relatively significant interest rate increases, the economies with relatively unstable political environments and pandemic situations may face greater challenges economically in the future.

As a result, financial conditions have tightened a tad in recent months under the influence of lower monetary growth, weaker momentum and increased volatility, but remain extremely easy overall.

## Is the worst of the pandemic over?

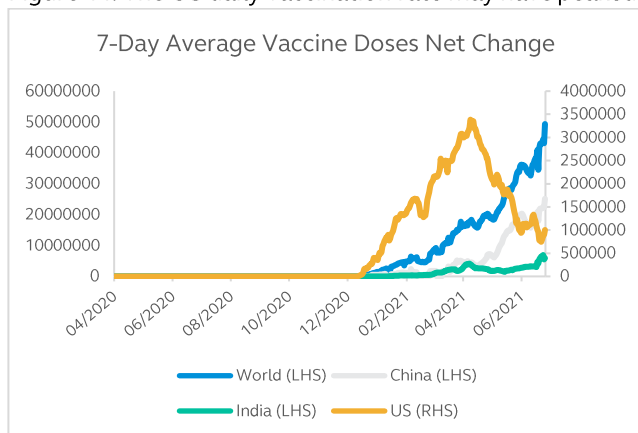
The global vaccination rate is steadily escalating, and the vaccination rate of part of Europe and Asia is beginning to catch up with the United States.

Figure 10: The confirmed cases worldwide fell back gradually led by Asia



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

Figure 11: The US daily vaccination rate may have peaked



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

As of June 30, confirmed cases worldwide have reached more than 180 million. Due to the rebound of outbreaks in Asia in the past quarter, the global seven-day average confirmed cases surged sharply to more than 880,000 in April. The number fell back to a four-month low of around 300,000 as the pandemic situations in most countries in the region were gradually under controlled (Figure 10).

The number and rate of vaccinations worldwide have been steadily increasing, with 20.2% of the global population having received two doses of vaccine by the end of June. Some countries in Asia are seeing rapid increases in vaccination rates. Take China as an example, the vaccination rate was increased to 44%. The same applies to Europe. Based on the current rate of vaccination, it may only take two to three more months for these places to achieve herd immunity (75% of the population is covered). Of course, with the increase in vaccination coverage, the daily vaccination rate may peak and fall. Take the United States, which was the first major country to implement vaccination programs, as an example. The average daily dose exceeded 3.3 million in mid-April. It has now fallen to about 1.1 million and may not cover 75% of the population until the end of the year (Figure 11).

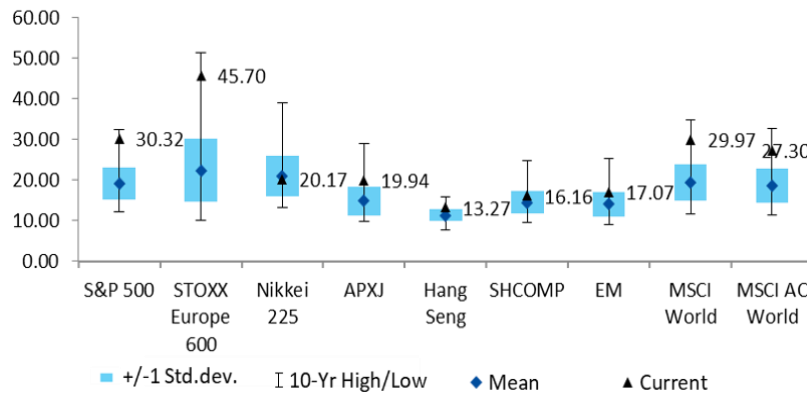
Generally speaking, the number of newly confirmed cases falls with the steady increase in vaccination rates. However, the number of confirmed cases in the UK has rebounded again recently to more than 20,000 cases per day, with most of them infected with the variant first seen in India. This has raised concerns on whether the pandemic can truly be controlled. We believe that as the economy resumes and restrictions are further uplifted, especially in Europe and Asia, there is a chance for infections to rebound in some countries. Although the threat of virus variants remains, the situation should be relatively controlled even if the pandemic rebounds. The incidences of severe symptoms and even deaths should be low, and the worst of the pandemic may have passed.



# Will equities continue to outperform?

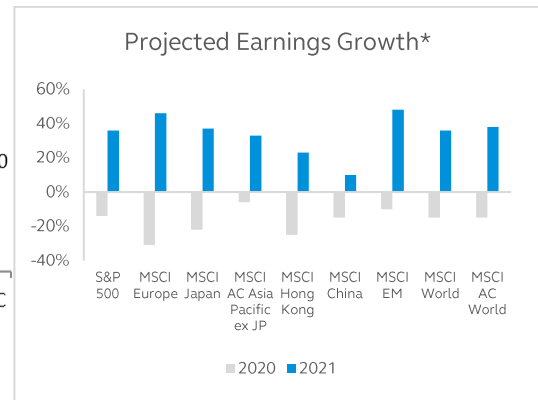
The fundamentals of the stock market remain relatively attractive, and it may still outperform the bond market despite more uncertainties.

Figure 12: Stock valuations are lower than that at the beginning of the year



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

Figure 13: The growth expectations of stock market earnings continue to rise



Source: Bloomberg, Factset, Principal Global Asset Allocation, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021. \*Estimates are sell-side analysts' bottom-up aggregated expectations.

Looking back at 2013, after Fed Chairman Ben Bernanke hinted that he would consider scaling back bond purchases, the stock market briefly retreated. However, at that time, bond yields rose sharply, and stock market returns still led the bond market, especially for US sovereign bonds. It is worth noting that after the stock market experienced short-term volatility, it rebounded trailing the economic trend. The S&P 500 Index recorded a return of more than 33% two years after Bernanke's remarks, outperformed all major bond categories.

As mentioned in the discussion on monetary policy, even if the Fed decides to tighten monetary policy, it does not mean that funds in the financial system will be withdrawn all at once. From the growth rate of the additional liquidity deposited by banks in the central bank, we can see that market liquidity remains abundant, and the cost of funds is expected to remain low for a period of time. These are still important reasons for supporting the upward trend of risky assets.

At the same time, the stock market fundamentals are favorable compared with the beginning of the year. Driven by cyclical industries, the growth

expectations of stock market earnings continue to rise. Taking the MSCI Europe Index as an example, earnings growth expectations increased from 31% at the end of last year to 46% currently. This has driven valuation compression, with most market valuations lower than that at the beginning of the year (Figure 12, 13). Since last November, there were steady inflows into the stock market, and the scale has reached US\$748 billion so far, clearly leading the bond, commodity and currency markets.

Although the economic growth rate of some developed markets may have peaked in the second quarter, with the support of the accommodative fiscal and monetary policies, the economic growth trend remains unchanged. Moreover, fundamentals are more attractive than at the beginning of the year. Equities may still outperform fixed income in the third quarter. But due to the uncertain factors that may drive market volatility, we have adjusted downwards our view on the stock market, but still slightly optimistic.

## Will cyclical and value-oriented investments continue to outperform?

Europe has been upwardly adjusted to slightly optimistic. Pay attention to cyclical sectors and technology stocks at the same time.

Q3 Outlook	Underweight	Slightly Underweight	Neutral	Slightly Overweight	Overweight
<b>Equities</b>	○	○	○	●	●
- US	○	○	○	●	○
- Eurozone	○	●	○	●	○
- Asia ex-Japan	○	○	○	●	●
- Japan	○	○	●	●	○
- HK	○	○	●	●	○
- China	○	○	●	○	○
- Other EMs	○	●	○	○	○



indicates a change in preference from the previous quarter

Among equity, we are slightly optimistic about the United States, Europe and Asia, while our views on Japan, China and Hong Kong are neutral. Other emerging markets (EMs) are slightly bearish.

**U.S.** - Existing savings buffers with US consumers due to fiscal transfers and potentially more stimulus provide further upside to US growth. Although the Fed has a chance to commence the discussion on reducing debt purchases, the initial trim is expected to be relatively small. The ample liquidity could still serve as a cushion for U.S. equities. If inflation stays for longer, signals of faster-than-expected rate hikes might trigger volatilities in stock market.

**Europe** - Several regions are pressing ahead with reopening amid falling COVID-19 infections while vaccination rate picks up steadily in Eurozone. In a reflationary backdrop, investors may continue to focus on value and cyclicity. Eurozone could benefit from the rotation with more skewness towards traditional value sectors, European Central Bank is expected to remain highly

accommodative for some time. Easy financial conditions should be supportive to equities.

**Asia ex-Japan** - COVID-19 vaccine rollouts have accelerated in many Asian countries, increasing the possibilities of a sooner-than-expected easing of some of the pandemic restrictions. Robust global manufacturing outlook and rising commodity prices lend further support to the growth in Asian economies, Asian equities may face headwinds from capital outflow if USD strengthens amid the Fed hawkish shift in tone.

**Japan** - Slower Japan vaccination rate than other developed markets elevates risk for Tokyo Olympics and raises concerns of COVID-19 resurgence, monetary policies are likely to stay accommodative given low inflation expectations. Japan's equities may benefit from the relatively low valuation and well capitalized companies in the long term.

**Hong Kong and China** - China's economic growth is likely to moderate in the second half of year as the catch-up of investment and domestic consumption might take longer. Domestic fiscal and monetary policies tend to normalize in order to balance the objectives of maintaining economic stability and solving long-term structural problems, but in the context of economic slowdown, policy will not be too tight. Hong Kong's economy is back on track, earnings growth may continue to improve in local stocks, and benefit from capital rotation.

**Other EMs** - Several central banks, including Brazil, have raised interest rates to curb inflation, and emerging markets may face tighter financial conditions. The debt levels in some emerging market countries remain high, which may hinder economic recovery, while the vaccination ratio is still relatively low. If the U.S. dollar reserves, emerging markets may be adversely affected.

**Sectors** - In the United States, for example, value stocks had once outperformed growth stocks by more than 10 percent so far this year. However, after the Fed hinted that it might increase interest rates earlier, the advantage of value stocks has significantly narrowed. We believe that the cyclical/value sector will still benefit from the investment themes of a strong global economic recovery and escalating inflation. The US job market is well on its way to a full recovery, and the Fed may not be able to raise interest rates before 2023. However, in the short-term, based on the belief that the hike in inflation is transitory, coupled with risk-averse factors, the yield on the 10-year US Treasury may not surge sharply during this quarter. This may benefit technology stocks with abundant cash flows and stable earnings prospects to recover some of the lagging gains. Both areas may be able to move up simultaneously during the third quarter.

## Will the interest rate for bonds rise further?

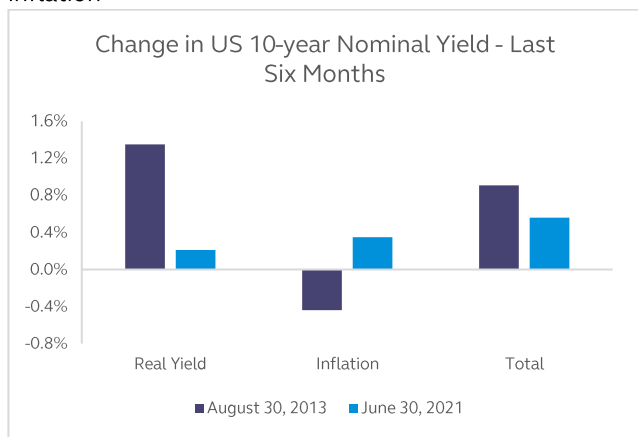
The US 10-year Treasury yield may not rise significantly for the remaining of this year. Our view on bond has been adjusted upwards to neutral overall.

Q3 Outlook	Underweight	Slightly Underweight	Neutral	Slightly Overweight	Overweight
<b>Fixed Income</b>	○	●	●	○	○
- Sovereign	●	●	○	○	○
- Investment Grade	○	○	●	○	○
- High Yield	○	○	○	●	●



indicates a change in preference from the previous quarter

Figure 14: The increase in bond yields this time was primarily attributed to the expectation of escalating inflation



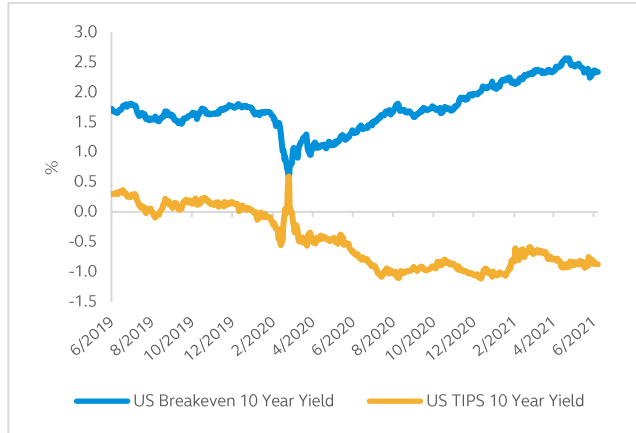
Source: Bloomberg, Principal Global Asset Allocation, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

The economic recovery and inflation expectations drove US long-term bond yields to soar in the first quarter, with US Treasuries recorded their worst performance since 1980. The rise in long-term bond yields moderated after entering the second quarter. The 10-year US Treasury yield dropped from 1.75% at the end of March to around 1.5%.

The market is worried that the current round of rising bond yields will be a repeat of the 2013 taper tantrum. However, through the dismantling of the long-term bond yield, we found that the situation this time is different from 2013. Treasury bond yields are comprised of real yields and inflation expectations. Take the 10-year US Treasury yield as an example, the yield rose from 2% to 2.8% within half a year after the Fed expressed its intention to scale back bond purchases in May 2013. Of these, the significant increase in real yields was the main reason for the rise in long-term interest rates.

In contrast, the increase in bond yields this time from below 1% to above 1.7% was primarily attributed to the expectation of escalating inflation, while the real yields remained negative to provide support for the economy (Figure 14). Compared with 2013, with the support of improved expectations for the economy and super ample liquidity, a taper tantrum is less likely to occur, and the low interest rate environment is expected to persist. Based on the belief that the rise in inflation is transitory, inflation expectation

Figure 15: Inflation expectation may have peaked in the short run



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

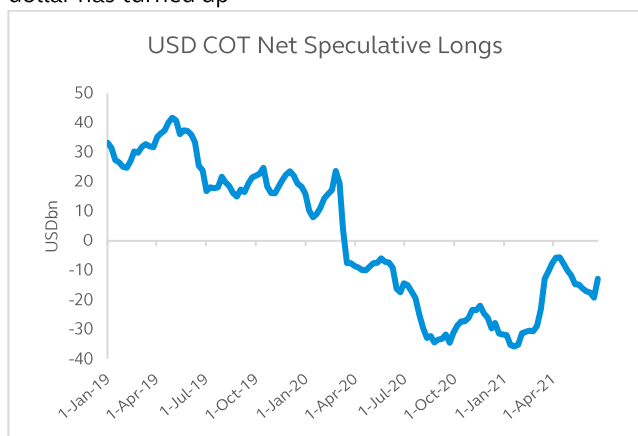
may have peaked in the short run. Coupled with the fact that real yields may remain low (Figure 15), adding together risk-averse factors, the US 10-year Treasury yield may not rise significantly for the remaining of this year, while the target yield for the third quarter ranges from 1.4% to 1.5%. Therefore, our view on bond has been adjusted upwards to neutral overall.

Where the perspective of asset allocation is concerned, corporate bonds are more attractive than sovereign bonds. Therefore, we are slightly bearish on sovereign bonds. As for investment-grade bonds, high-rated bonds have the opportunity to continue to attract capital inflows owing to ample market liquidity. Yet, the credit spread is close to the bottom of the current cycle, and there is little room for further compression in the future. Our view remains neutral. On the other hand, high-yield bonds are slightly bullish. High-yield bond credit spreads are relatively high, which may offset potential interest rates pressure and benefit from the global economic recovery. At the same time, corporate earnings tend to be positive, and the trend of high-yield bond rating upgrades is expected to continue. The default rate is expected to continue to fall, which may benefit the performance of high-yield bonds.

## Has the U.S. dollar bottomed out?

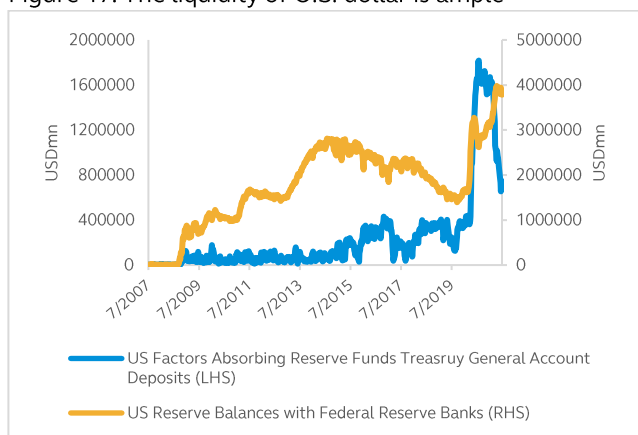
The dollar's low for this year may have appeared in the second quarter. RMB faces downward pressure.

Figure 16: The amount of money traders bet on the US dollar has turned up



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

Figure 17: The liquidity of U.S. dollar is ample



Source: Bloomberg, Principal Asset Management Company (Asia) Limited. Data as of June 30, 2021.

The Dollar Index fluctuated between 89.2 and 93.4 in the first half of the year, mainly affected by factors such as the local economy, inflation, and monetary policy. Looking ahead to the third quarter, the US dollar may stay volatile. As US inflation is expected to remain high in the near term, the Fed may reveal its intention to tighten policy during this quarter. According to futures market data, the amount of money traders bet on the US dollar has turned up after the June Fed

meeting (Figure 16). The dollar's low for this year may have appeared in the second quarter.

However, any significant increases in the U.S. dollar may remain impassable. On one hand, the vaccination rate in the United States has gradually slowed down with the average daily vaccination rate fallen by more than two-thirds from its peak. As the vaccination rate in European and Asian countries catches up with the United States, the U.S. economic recovery may no longer be the driving force behind the dollar. On the other hand, as the US Treasury Department gradually releases U.S. dollar liquidity held in the Fed's Treasury General Account (TGA), bank deposit reserves have been pushed up to a historic high of US\$3.8 trillion. The liquidity of U.S. dollar is ample (Figure 17). Finally, the fiscal policy introduced and planned has kept the U.S. fiscal deficit at a high level of 15% of GDP, increasing the dollar's upward resistance. The U.S. dollar index may fluctuate between 90 and 94 in the third quarter.

EUR vs. USD: The economic recovery in the eurozone is accelerating. With the acceleration of COVID-19 vaccinations, a recovery in the service and manufacturing sectors is expected to be further strengthened. Inflation pressures in the region are relatively under control, and there are disagreements within the European Central Bank (ECB) on whether to maintain the current asset purchases. It is believed that the ECB will be more patient in tightening monetary policy. There is a short-term deviation in monetary policies between the United States and Europe, the interest rate difference between the United States and major European countries is expected to remain stable, while the euro lacks upward momentum for the time being. We believed that euro may fluctuate between 1.16 to 1.2 against the dollar in the third quarter.

USD vs. offshore RMB (CNH): With the possibility of a slowdown in economic growth during the second half of the year, monetary policy in the mainland China may not be significantly tightened while normalizing and maintaining moderate liquidity. The impact of the policy on the RMB is expected to be relatively neutral. In the short-term, the U.S. dollar will be a major influential

factor in the RMB's trend. As U.S. monetary policy is expected to be tightened gradually, the US dollar may strengthen against RMB in the second half of the year and is expected to be supported at 6.4 in the third quarter, with a chance to reach 6.6.

## DISCLOSURES

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