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2024 Perspectives

The year of the pause and the pivot

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Executive letter

KAMAL BHATIA, CFA
Global Head of Investments

Investors entered 2023 facing the daunting conflagration of geopolitical risk in Eastern Europe, China's dramatically slowing economy, and the dawn of a new central banking era, as ten years of quantitative easing began to phase out. That the year saw global growth—propelled by a remarkably resilient U.S. economy and stock market—raises the bar even higher and, in 2024, investors need to brace for the very real potential of large market shocks.

As investors face a "new normal" with lower returns and higher volatility, they need better ways to diversify portfolios to generate returns for the future as well as timely insights that serve as a resource on where markets are headed. Our teams are keenly focused on delivering forward-looking solutions and insights to help you achieve your investment goals through our global and local teams and distribution partners.

This is not only an environment where active management is well-placed to deliver strong outcomes for investors, but also one where asset managers have a responsibility to help you—our clients—navigate this complex landscape and achieve your investment goals. As client demands evolve, we continue to expand the breadth and depth of our capabilities as well as key investment team hires to support. Alongside our clients, we have grown to nearly 860 investment professionals globally, with local analysts and investors in 25 markets.

Thank you again for your continued support and for trusting us to be your preferred partner. We wish you a happy end to your year and look forward to continued collaboration together.

MACRO

In 2024, expect challenges for the U.S. economy as resilience wanes amid rising household debt and job cuts. Global growth may slow, posing risks amid geopolitical tensions, but it could ease inflation pressures. Prepare for volatility, but also opportunities ahead.

Pivot, pivot, PIVOT

A slowing global economy in 2024 will be vulnerable to shocks and volatility

SEEMA SHAH | Chief Global Strategist

For the bulk of 2023, investors were almost universally surprised by global growth—by the extent of U.S. resilience, and, on the other side, the depth of China's weakness. Next year, the macro backdrop may look a little different.

The unprecedented policymaker actions designed to immunize the global economy during the height of the pandemic were extraordinarily effective—almost too effective, though, as they dulled the impact of central bank tightening. But the nuances of the post-pandemic economy only deferred, not canceled, the economic pain.

In 2024, the U.S. will likely present a challenging story for investors as economic resilience begins to fade. Post-pandemic excess savings are almost exhausted, while fixed-rate loans locked in at low rates are expiring, opening the door for a sharp rise in household debt servicing costs. Labor market cracks are starting to show as a growing number of firms announce headcount reductions and take a more cautious tone to expense discussions.

The Federal Reserve's (Fed) lending program at the height of the pandemic led to elevated debt issuance in 2020 and 2021 and at very low rates, limiting companies' refinancing needs. A higher percentage of corporate bonds will mature in 2024, requiring refinancing at significantly higher rates than most companies' existing loans. A rising number of households and corporates will no longer be cushioned from the higher interest rate environment and will face a higher net interest burden next year.

However, a sharp economic collapse in the U.S. is not in the cards. The 2001 and 2008 recessions were particularly deep due to a significant buildup of debt-related excesses. Unlike those recessions, household balance sheets are currently in reasonably good shape, and corporate balance sheets—although somewhat inflated—are not burdened by particularly concerning borrowing dynamics. Investors should be preparing for a historically short and shallow U.S. downturn.

> "However, policy rates are **not about to quickly march back down to zero**, as a soft slowdown only requires a soft cutting cycle."

In China, growth is already showing signs of bottoming, but the pace of recovery is uncertain and highly dependent on policy stimulus. Policymakers have pivoted away from their deleveraging campaign to a pro-growth policy, but the stimulus is unlikely to be sufficiently meaningful to deliver a significant boost to the property sector and, therefore, overall economic growth.

Even with strong contributions from economies such as India and Japan, tepid growth from the U.S. and China—and, by association, Europe—implies a slowdown in overall global growth in 2024. Nothing appalling, but it does render the global economy vulnerable to additional shocks. The recent rise in geopolitical tensions, oil prices, and the U.S. dollar will need to be watched carefully by investors. Indeed, risk assets may be set for a volatile period in early 2024. Yet, investors should also be encouraged that the slowing growth environment could drain out the most stubborn of inflationary pressures, opening the door to gradual policy easing in mid-2024 and reducing the discomfort that has plagued markets since rate liftoff last March.

However, policy rates are not about to quickly march back down to zero, as a soft slowdown only requires a soft cutting cycle. Central bankers will likely be reluctant cutters, wary of the structural inflation dynamics that have become gradually embedded in the global economy. Deglobalization, green energy initiatives, demographics, and geopolitical divisions all add up to a higher underlying inflation rate, a higher neutral interest rate, and a persistently watchful eye from central bankers.

Bond yields themselves face a higher-for-longer narrative. In addition to the structural inflation dynamics, Treasurys are also being confronted by a ballooning U.S. fiscal deficit, resulting in ongoing large-scale Treasury issuance. With the Bank of Japan's eventual move away from ultra-easy monetary policy drawing incremental demand away from U.S. Treasurys, the U.S. government will need to offer a higher interest rate on its bonds to attract buyers. Once slowing growth and peak Fed funds mark the high point for the recent bond rout, yields may ultimately settle at a more elevated level than in the past 15 years.

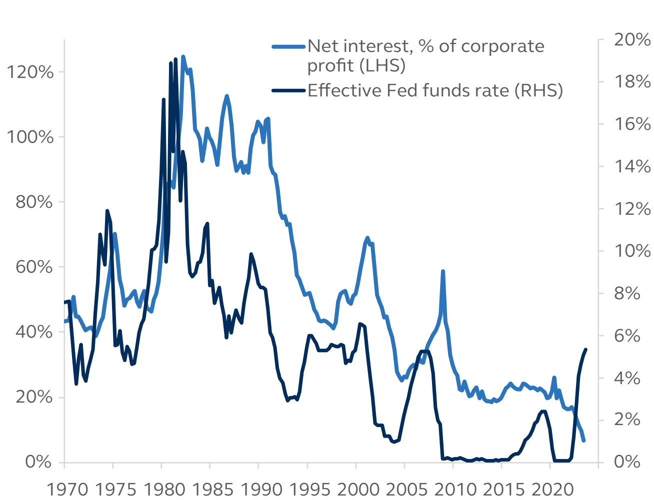
The year ahead will likely present a greater opportunity set than has been available in many years:

- The recent market pullback in several sectors and smaller cap sizes means cheaper valuations (providing investors with important opportunities to gain exposure to secular tailwinds).
- The approaching end to monetary tightening could open the door to a new cycle of equity gains.
- Higher bond yields imply greater volatility and lower long-term growth.
- Higher rates indicate that bonds can finally be more than a diversification tool—the "income" is back in fixed income.

2024 will be the year of the pause and the pivot. Investors should prepare for near-term volatility but also actively position for relief, stabilization, and recovery once global central banks start to cut rates.

Corporate interest payments and Fed funds rate

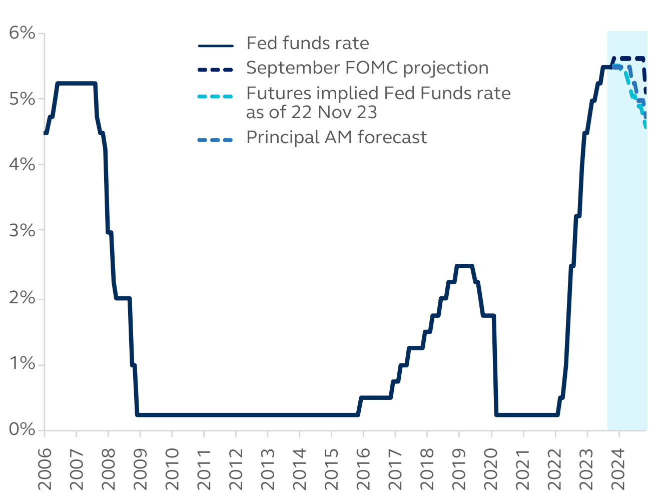
1970 - present



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

Federal Reserve policy rates path

Fed funds rate and September FOMC forecast



Source: Federal Reserve, Bloomberg, Principal Asset Management. Data as of November 22, 2023.

Japan's policy normalization

A shift in BOJ policy may start drawing funds away from U.S. Treasurys

HAN PENG, CFA | Director, Quantitative Strategist

Unlike the broad developed markets in which elevated inflation created stress and led to aggressive tightening in monetary policy, the Japanese economy is benefiting from a longed-for reflation. Japan's core inflation has risen above 2%, reaching 42-year highs in 2023 and increasing hopes that Japan could finally be out of its deflation nightmare.

> "Japan's core inflation has risen above 2%, **reaching 42-year highs in 2023** and increasing hopes that Japan could finally be out of its deflation nightmare."

In response to persistently depressed inflation pressures, the Bank of Japan (BOJ) adopted a negative interest rate policy in 2016, cutting official policy rates to -0.1% and introducing yield curve control (YCC) to keep long-term yields restricted to a tight band. In the last 12 months, the BOJ has responded to rising domestic inflation pressures by adjusting the YCC policy three times, effectively allowing higher Japanese government bond (JGB) yields. The central bank also indicated that additional evidence of sustainable inflation and wage growth will be required for further policy normalization. This cautious attitude implies that policy normalization is likely to be gradual, with the BOJ potentially choosing to maintain the YCC policy but increase the flexibility, permitting policy rates to rise back to zero but not higher.

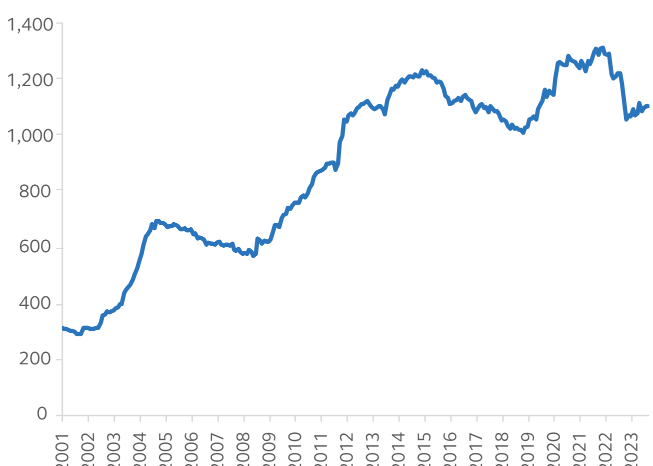
For decades, low interest rates and a lack of investment opportunities have prompted Japanese investors to look outside their economy, becoming major fund providers to global markets. Indeed, they are the largest foreign owners of U.S. Treasurys, holding over $1.1 trillion. However, the BOJ's new policy regime—allowing domestic yields to drift higher—may start changing that narrative. Higher JGB yields could gradually draw Japanese investors away from global bonds, particularly U.S. Treasurys, signaling a significant shift in the global investment landscape.

Rising volatility in global bond markets makes the impact of a BOJ policy shift difficult to predict. If U.S. Treasury yields remained elevated, BOJ policy normalization would likely reinforce and exacerbate a sharp global bond sell-off. If the BOJ unwinds its easy monetary policy at a time when global yields are already on a downward trend, the outcome would likely be less impactful on global bonds.

In either case, BOJ normalization risks de-anchoring global bonds, with global yields eventually settling at a higher level in the next decade than the prior one. For investors, keeping a close eye on Japan has become more critical than ever.

U.S. treasury bonds held by Japan

2023 year-to-date, total return in U.S. dollars



Source: U.S. Treasury Department, Principal Asset Management. Data as of August 31, 2023.

EQUITIES

Entering 2024, central bank policy changes, rising government debt, geopolitical tensions, and consumer vulnerabilities will likely challenge equity markets. Active managers may find opportunities in overlooked sectors like energy and materials. Amid uncertainty, focusing on investing fundamentals is crucial.

No crystal ball for 2024

Prioritize focusing on investment fundamentals

GEORGE MARIS, CFA | Chief Investment Officer, Global Equities

Going into 2024, visibility into equity fundamentals—and across almost all asset classes—is as opaque as it's been in years, making it challenging to know what is going to happen by the end of the week let alone next year.

At the end of 2023, the economic backdrop—especially in the U.S.—is more resilient, but ever more intertwined with central bank policy. While many investors have been focused on the historic degree of Fed rate hikes, the reversal of quantitative easing (QE), which is set to remove trillions of dollars from the Fed's balance sheet, will have an equally outsized impact on the economy in the years to come. To put it into perspective, the Fed's balance sheet was roughly $900 million prior to embarking on QE in the second half of 2008 and approximately $4.2 trillion prior to the onset of the pandemic at the end of February 2020; at the time of writing, it exceeds $7.9 trillion. Many global central banks are too tasked with tightening their massive balance sheets, including the European Central Bank and the Bank of Japan.

With that in mind, we are entering 2024 amid a backdrop of challenging monetary policy globally. Fiscal policy is unlikely to improve given rising government debt levels. With government interest burdens rising, governments will be constrained in spending their way out of economic challenges. Geopolitical concerns are a further headwind as governments will need to maintain a focus on defense spending, which is not only a pressure on budgets but also inflationary. Despite the more constrained capacities of governments to support growth, inflation remains at higher levels than in the past several years with wages and raw materials providing stickiness. Consumer strength—buoyed by low unemployment—helped drive economic growth this year. But with economic growth more challenged and inflation persistent, concern is increasing over the consumer's ability to weather these challenges. If the consumer falters, corporate earnings are likely to follow suit. As we glance into 2024, we see an equity market that is narrow and not particularly cheap, presenting challenges and opportunities.

"As we glance into 2024, we see an equity market that is narrow and not particularly cheap, **presenting challenges and opportunities**."

Despite a singly positive earnings season for the third quarter of 2023, companies are indicating a greater degree of caution for 2024, primarily driven by concerns relating to the consumer. Fiscal support provided by the government during the pandemic allowed most consumers to enter 2023 with reduced interest rate sensitivity. But these support structures are winding down, exposing consumers to the full burden of higher-for-longer rates. It is this higher-for-longer narrative that has caused much of the recent spike in global bond yields, challenging the equities markets' prediction and pricing in of a soft landing in 2024. With limited prospect of an upgrade to earnings expectations, equity market returns are likely to be muted until bond yields peak, leaving broad equity markets with little upside going into 2024.

The good news is that there are appealing pockets in the equity market for active managers for the year ahead, many of which are in places that have not recently been generating much attention, including energy and materials.

While there is certainly no shortage of uncertainty as we look to the new year, there is also opportunity and reason to maintain a balanced perspective. In this environment, what you buy and the price you pay matters. Merely buying the market, rather than seeking attractively valued companies that can weather and grow in uncertain times, is risky. As we head into an uncertain and unclear 2024, investors should return to focusing on investing fundamentals.

Amid a subdued economic climate in 2024, avoid speculative bets

Sound investment choices will give investors peace of mind during economic turbulence

SARAH RADECKI, CFA | Portfolio Manager, Equities

From our discussions with management teams, it's clear that economic activity has decelerated, and sales have been hindered by inventory destocking. Nevertheless, there are several encouraging developments, including improvements in supply chain disruptions, reduced freight expenses, and the moderation of raw material prices from elevated levels. For companies with differentiated product offerings and a prudent approach to financial health, the economic outlook is promising. However, the year ahead is likely to be defined by the ongoing tension between economic expansion, cost dynamics, and interest rates, presenting a spectrum of challenges and opportunities for investors.

Our investment strategy is based on fundamental research that enables us to identify quality businesses in each sector and participate in market appreciation while muting downside risk. Though this process likely means returns won't lead the way when the market is flying higher, our dedicated approach has consistently led to upside participation and downside risk mitigation through various market environments.

> "As investors enter **a more subdued economic climate in 2024**, it will be prudent to avoid speculative bets."

As investors enter a more subdued economic climate in 2024, it will be prudent to avoid speculative bets. Equally, however, there's risk associated with parking funds in fixed-return investments that may gradually erode due to inflation. Instead, investing in high-quality companies with sustainable competitive advantages, growing dividends, strong management teams, and robust balance sheets capable of withstanding challenging times should offer attractive relative returns—and the stability that comes with sound investment choices.

Tuning out short-term noise

Why owner-operators are positioned to succeed

HANS VANDER PLAATS, CFA | Client Portfolio Manager, Equities

For at least the last year, there's been no shortage of talk about the soon-to-arrive recession. For long-term investors, however, focusing on the key drivers of success at the company level, rather than attempting to time the market or make macro forecasts, is more impactful.

A backdrop of cheap money made it easier to run companies over the past several years. The rewards for being patient, frugal, and thoughtful about risk were less obvious. CEOs that remained disciplined —focusing less on shorter-term noise—placed their companies in a better position longer-term to navigate economic slowdowns and prosper, regardless of how the market shifts.

"Looking ahead to 2024 and beyond, the **best CEOs will continue to stand out**."

Looking ahead to 2024 and beyond, the best CEOs will continue to stand out. Management always matters, but even more so in a landscape where economic tides may turn—and we especially appreciate investing with owner-operator CEOs when conditions become more difficult. These CEOs have large ownership stakes and specific characteristics—love for the business, unclouded motivations, and a long-term orientation when allocating capital—that make their companies impressively resilient.

FIXED INCOME

Despite 2023 ending on a strong note, 2024 brings expectations of economic slowdown. While inflation is likely to subside, higher borrowing costs will challenge consumers. Opt for high-quality, short-maturity yield assets amid a central bank rate pause.

Focus on the journey, not the destination

Fixed income investing during an economic slowdown

MICHAEL GOOSAY | Chief Investment Officer, Global Fixed Income

For the better part of 2023, investors were waiting for the other shoe to drop—for something to break and create the impetus for the coming recession. Many thought that this might happen with the mini-banking crisis in March, but the economy proved stubbornly resilient and has ended the year on strong footing. However, we've reached the point in the economic cycle where, historically, something starts to crack. Looking to 2024, we are anticipating an economic slowdown. We believe inflation will continue to slowly subside while higher borrowing rates will put a strain on consumers. And the Fed—along with other central banks globally—will pause their rate hiking campaign and hold rates at elevated levels for an extended amount of time.

The end of the rate hiking cycle and the impact of higher for longer

After experiencing a series of rate hikes that have impacted short- and long-term interest rates, the effects of higher-for-longer interest rates on growth, inflation, and the consumer are becoming evident. Historically, the end of the rate hiking cycle is an optimal time to add fixed-income investments and to consider taking on interest rate risk in the form of duration.

Shifting from money market investments, which have seen significant inflows in recent years, and extending out to short-term income, core and core plus fixed income can introduce high-quality spread assets that should benefit from the Fed's pause in 2024. With inflation rolling over and growth subsiding, moving further out the yield curve and taking more interest rate risk is prudent. This is not, however, a great environment for riskier asset classes such as high-yield emerging market debt and lower-quality investment-grade corporate bonds.

To this point, the U.S. consumer has been resilient

One of the major indicators to monitor for a potential recession is the consumer, who is currently facing risks due to increased borrowing costs and a shifting job market. Since 2020, U.S. consumers have been buoyed by relatively strong employment paired with excess savings stemming from the COVID-19 lockdowns and stimulus, resulting in spending levels that are not typical of this point in the cycle. Looking to 2024, pay close attention to weekly jobless claims and monthly employment reports, looking for any changes in hours worked and average hourly earnings; these are changes that could be viewed as early indicators of cracks starting to show in the labor market and could spell trouble ahead for consumers.

Ultimately, fixed income investing at this point in the cycle remains dependent on timing—and in the absence of complete clarity about the coming recession, owning high-quality, short-maturity, yield-oriented securities will be critical. Stay focused on the journey, rather than agonizing about the destination.

High yield? In this environment?

Five compelling reasons high yield could deliver in 2024

JOSH RANK, CFA | Portfolio Manager, Fixed Income

The fixed income market is poised for another year of volatility, but there are reasons to believe that high-yield bonds can deliver attractive returns in 2024.

1. Only $56 billion in high-yield bonds are set to mature in 2024, a mere 4.6% of the index. This is significant because maturities often correlate with bankruptcies, the principal drag on performance in the high-yield asset class. With such a small portion of high-yield bonds maturing in 2024, the risk of widespread defaults is significantly reduced.

2. Elevated starting yield can enhance medium- and long-term returns in the asset class. Since 2020, the median 12-month return has been 14.9% when starting yields are between 9-10%, suggesting that the current starting yield could be a harbinger of solid returns for investors in 2024.

3. While spreads in high yield may not currently reflect an imminent deep recession, any future spread volatility caused by macroeconomic factors will likely be offset by the historically elevated yield cushion of the asset class.

4. The quality of high-yield bonds has shown improvement, with CCC and below debt accounting for only 12% of the index, compared to historical levels exceeding 20%. This suggests healthier fundamentals and likely less jump-to-default risk for investors.

5. As pension funding status improves, there may be a shift from equities to fixed income—including high-yield investments—to decrease volatility in plan assets. High-yield bonds can provide a stable, income-generating component in an investment portfolio, particularly for pension funds seeking to manage risk while achieving their funding goals.

Under-owned and under-priced

Emerging market debt is poised for a rebound in 2024

DAMIEN BUCHET, CFA | Chief Investment Officer, Principal Finisterre

Emerging market debt (EMD) is entering 2024 similarly to 2023—under-owned and under-priced with risks being properly exposed and priced in. With the current landscape dominated by the U.S. economy, a U.S. economic slowdown in early 2024 could serve as a catalyst to entice a sustainable bounce in risk appetite and an increase in EMD allocations from historically low levels.

The economic story for many EMs, despite odds to the contrary, is reasonably strong. Growth and fiscal balances have held up better than most expectations, while EM central banks have been much more pre-emptive in managing inflation than their developed market counterparts. The default events and macro stresses have remained mostly confined to well-flagged countries with unmanageable debt loads or obvious policy credibility issues.

With limited investor ownership and subdued sentiment, EMD presents exciting opportunities. The income stream will remain a reliable component of returns via a diversified range of short-duration, high-yielding, commodity-sensitive sovereign credits in Africa, the Middle East, and Latin America; select high-yield corporates with low indebtedness and visible cashflows in Brazil, Mexico, and South Africa; and subordinated financials from better-rated Asian, Mexican, and Eastern European banks.

> "With limited investor ownership and subdued sentiment, **EMD presents exciting opportunities**."

Beyond income, increased duration exposure makes sense once a U.S. slowdown is confirmed. This can come from EM USD long-duration credits or high-yielding local bonds that are overpricing future inflation risks through high real yields. The management of currency risk must remain tactical and selective, but the USD could see periods of weakness, allowing for possible capital gains from EM foreign exchange.

Finally, a selection of small positions in more distressed/restructuring situations can provide attractive optionality to an EMD portfolio, as the stepped-up support of the International Monetary Fund and multilaterals and a softening of China's creditor demands in some countries has allowed progress in several restructurings.

From TINA to TARA

Fixed income's shifting opportunity set in Asia

HOWE CHUNG WAN | Head of Asia Fixed Income

The 2024 investment outlook for fixed income investors in Asia suggests an increased focus on carry trades, a consideration of regime shifts in China and Southeast Asia, and a careful analysis of the winners and losers within fiscal activism measures.

The shift away from ultra-low interest rates makes carry trades more appealing than beta trades. It infers that fixed income investments now present a viable option for both savers and investors. The significant move from TINA (there is no alternative) to TARA (there are real alternatives) provides new opportunities for investors to park their money and generate returns.

While we approach China with macro caution, we remain micro-optimistic. Regime shifts in the global economic landscape, especially in China and Southeast Asia, will likely offer opportunities in the period ahead. For instance, investments centered around the middle-class consumption narrative and driven by e-commerce/digitalization are favored.

Green and sustainable prospects, along with companies diversifying away from China, should benefit countries like India, Malaysia, and Indonesia in the years ahead.

Fiscal activism is also likely to be an important driver of markets in the year ahead and should play a crucial role in offsetting monetary tightening. The fiscal easing measures implemented by central banks have had a positive impact broadly, but there will be winners and losers with these policies. In China, it will be crucial to closely monitor the support for state-owned enterprises and local government financing vehicles to avert a possible debt crisis stemming from property market challenges.

By staying attuned to these trends and factors, investors can position themselves to capitalize on emerging opportunities and navigate potential risks in the ever-evolving fixed income landscape in Asia.

Not your grandmother's preferreds market

Portfolio structure to remain paramount in 2024

PHIL JACOBY | Chief Investment Officer, Spectrum Asset Management

The landscape of preferred and capital securities has evolved significantly, departing from the traditional realm of fixed-rate perpetuals associated with utilities and railroads. Today's market is predominantly characterized by a "hybrid" approach, where over 75% of securities are adjustable rather than fixed rate for their entire lifespan.

> "Today's market is predominantly characterized by a "hybrid" approach, where over 75% of securities are adjustable rather than fixed rate for their entire lifespan."

One prevalent form of adjustable-rate capital security is the five-year fixed-to-refixed (FtR) format. These securities reset their terms after five years, aligning with the prevailing conditions in the market, specifically the yield on five-year Treasurys at that time.

During the issuance wave of 2020-2021 that coincided with a period of accommodative monetary policy, FtR hybrid securities were issued at relatively low coupons (e.g., 4%) but with substantial spreads (e.g., +300-325 basis points). However, these spreads were set to reset five years later. Today, these securities are trading at discounts of 10–15 basis points (bps) due to the Fed's subsequent increase in the federal funds rate of more than 500 bps in just under two years, raising the U.S. Treasury yield curve and negatively impacting the prices of fixed income instruments.

The behavior of these securities hinges on the width of the backend reset spreads. If the spreads are wide enough, the anticipated new coupon—calculated based on today's five-year UST yield—can act as a quasi-maturity because the securities are expected to be redeemed at par thanks to a more attractive current market spread. If the backend spread is narrower than the current market spread, while the coupon may reset higher, the paper is unlikely to be redeemed since the initial issuance spread is more favorable for the issuer to leave outstanding.

In either scenario, the security's price should rise or be "pulled toward par" as the coupon reset date approaches, since that reset will be based on the five-year UST rate at the time. From a price perspective, it becomes irrelevant whether Treasury yields rise or fall, as an increase in yields can lead to a higher coupon and decreasing yields tend to drive up bond prices.

In the period ahead, investors who can appropriately balance these FtR securities will likely be less susceptible to fluctuations in interest rates. Given the ongoing and expected volatility in fixed income markets, portfolio structure remains paramount.

Jeopardizing fully funded status? Better not be

Steering defined benefit plans toward continued stability

OWAIS RANA | Head of Investment Solutions

The substantial rise in the long-term U.S. Treasury yield curve combined with broad U.S. equity markets' impressive, albeit surprising, returns has provided a significant boost to the financial health of the U.S. corporate defined benefit (DB) pension sector. Heading into 2024, the pressing question for those responsible for these long-term obligations is whether they are willing to jeopardize their hard-won, fully funded status—an achievement that has taken nearly 15 years to accomplish. Their answer needs to be a resounding "no."

Assuming that the much-anticipated recession is both short and shallow in 2024 and that geopolitical tensions remain contained, we anticipate and hope that the U.S. corporate DB pension industry will persist in its de-risking strategy. This entails selling equity-like assets in favor of increasing bond investments, thereby solidifying their fully funded position. This decision should allow these sponsors to minimize the risk of putting more contributions into the pension plans if the markets turn. And given the potential surge in demand for long-dated U.S. Treasury and corporate bonds, it would be prudent to position at the forefront of the queue, especially considering the limited supply of these securities relative to the size of the DB pension market.

> "We anticipate and hope that the U.S. corporate **DB pension industry will persist in its de-risking strategy**."

MULTI-ASSET

Despite 2023's surprises, 2024's outlook is complex. Amid the uncertainty, strategic allocation and active management can create opportunities for investors in the year ahead.

Multi-asset investing in 2024

Investment hubris is unlikely to gain wins

TODD JABLONSKI, CFA | Global Head of Multi-Asset and Quantitative Investments

2023 has been a surprising year on many fronts. A year ago, many investors and pundits expected a recession in 2023 and advised positioning investments accordingly—favoring fixed income over equities while expecting sluggish equity performance, limited interest rate risk, and challenges in speculative credit.

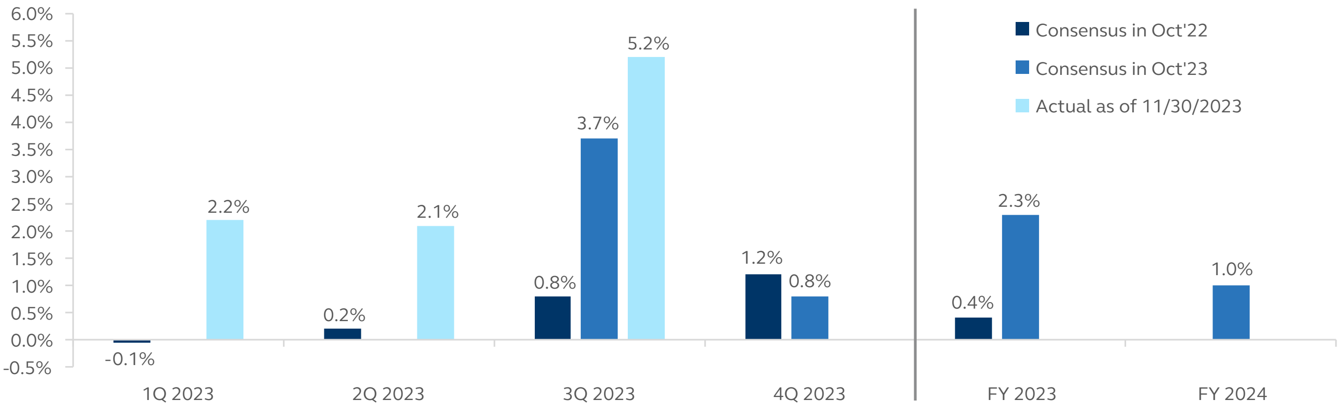
However, the U.S. economy has vastly exceeded expectations, with stronger GDP growth despite higher rates and tighter financial conditions. While Fed tightening has started to put pressure on inflation, it remains a concern for the inflation-wary Fed governors. In turn, interest rate risk has been quite high, while credit risk has generally been rewarded. The capital markets have also seen unexpected developments, such as very significant gains in a small group of technology-focused companies despite rising rates and stretched valuations, lifting U.S. indices and concealing weakness in large segments of the equity space. All these surprises create a complex outlook for 2024, raising questions about the appropriate asset allocation for the year ahead.

Tactical runs look unattractive. Rely on strategic diversification and active management.

Investors would be wise to limit tactical risk taking and instead maximize their strategic diversification and pursuit of issue selection returns. For starters, 2023's strange and surprising economic/market performance makes forecasting 2024 even more difficult. Throw in the increasing importance of non-market factors

2023-24 real GDP consensus estimates & 2023 actuals

Quarterly QoQ SAAR % & FY YoY%



Note: Consensus is median estimate of over 60 surveyed economists.
Source: Bureau of Economic Analysis, Principal Asset Management. Estimates as of October 31, 2023. Actuals as of November 30, 2023.

(e.g., fiscal policy, geopolitical conflicts, U.S./China trade tensions), and the ambiguity meter starts to tick relatively high. We're neutral among equities, fixed income, and alternatives in our multi-asset views, preferring to take advantage of long strategic asset allocation and active issue selection returns, positioning our portfolios for future opportunities.

Be prepared to respond if unforeseen events produce rare entry points.

An absence of rate cuts next year, expanding conflict in Europe and the Middle East, and Federal Reserve-market participant misalignment sit at the top of the list of risks capable of drawing down equity prices and widening credit spreads.

Despite economic slowdown risks, fundamental expectations at the end of October 2023 are fairly healthy.

- Worldwide and U.S. sales growth is forecasted to accelerate from 0% and +2%, respectively, in 2023 to +5% in 2024.
- S&P 500 earnings growth is forecasted to accelerate from +1% in 2023 to +12% in 2024.

As such, there is room for fundamentals to disappoint if the higher rates eventually slow the U.S. economy. In light of these risks that would put significant downward pressure on equities and other risk assets in 2024, having a plan in place to overweight risk assets and participate in the recovery is desirable. Both Latin American and U.S. small-cap equities have already achieved extremely low valuations and could be some of the first groups to rebound in sentiment.

Don't expect significant policy rescue in 2024.

After years of substantial fiscal stimulus, it is possible that fiscal policy spending worldwide could slow as rising debt levels attract market scrutiny and elevated interest rates challenge borrowers. We believe that expectations for significant U.S. rate cuts in 2024 will likely be unfilled, as stubborn inflation will require at least holding a hawkish line on short-term policy rates.

Subtle asset allocation enhancements can have significant impacts on portfolio risk exposures and diversify return drivers.

Heading into 2024, tactical preferences include:

- Investment grade corporate credit over U.S. Treasurys
- U.S. large-caps over U.S. small-caps
- Japan equities over Europe equities
- Brazil equities over China equities

Although the investment outlook for 2024 may be uncertain and challenging, there will likely be opportunities arising from valuation dispersion and macroeconomic variability. Expect strategic asset allocation and positive active management to drive performance in the next year.

Preparing for the influence of the Three Ds in 2024

Prioritize real assets for greater predictability of returns

MAY TONG, CFA | Portfolio Manager, Multi-Asset

Investors may be witnessing the initial phases of a structural macroeconomic transformation in which deglobalization, decarbonization, and demographics (the Three Ds) should emerge as significant influencers of asset class performance. Within this evolving landscape, the frequency of inflation shocks may rise, resulting in increased market volatility, higher interest rates, and stronger correlations between traditional stocks and bonds. As such, relying solely on commonly utilized inflation hedges such as REITs and TIPS may prove disappointing. Instead, prioritizing real assets in portfolios could prove to be a valuable strategic allocation.

> "Investors may be witnessing the initial phases of a structural macroeconomic transformation in which **deglobalization, decarbonization, and demographics (the Three Ds)** will emerge as significant influencers of asset class performance."

Diversification

With a minuscule overlap of only about 5% vs. a 60-40 benchmark, and backing by physical assets that provide essential services and are often assets to the economy, adding real assets can provide greater predictability of returns while lowering the overall risk profile for a portfolio.

Inflation mitigation

While most real assets possess contractual or implicit inflation linkages, sensitivity and effectiveness vary. Understanding the rolling correlations of real assets along with growth and interest rate interaction is critical.

Total return potential

A differentiated source of stable margins and recurring yields can aid in increased income and enhanced returns.

Real assets exhibit a diverse range of behaviors, each unique to different sectors (such as infrastructure, real estate, global natural resources, and commodities), asset classes (like debt and equity), and markets (public and private). These assets respond differently to shifts in economic growth, inflation, and interest rates, both in terms of timing and magnitude. In light of this diversity and the emergence of the Three Ds, strategically allocating to actively managed real asset exposures can offer valuable advantages, particularly in this new regime.

Alternative investments face challenges amid ongoing monetary policy measures. A potential U.S. recession and stricter banking sector regulatory oversight add complexity. However, opportunities do exist, and private equity, real estate, and inflation-sensitive assets may thrive in 2024.

Private market investing in 2024

Identifying opportunities as the tide of tightening recedes

TODD EVERETT | Global Head of Private Markets

Private market investments are undeniably tied to the use of leverage, so the sector is eagerly awaiting relief from the ongoing accumulation of monetary policy measures aimed at curbing inflation. Each rate increase has tested investor confidence, leading to the recalibration of asset valuations, delays in negotiations, heightened selectivity, and subdued capital mobilization. If the base economic scenario for 2024 is one of a shallow U.S. recession, additional consideration needs to be given to weakening demand. Although the cycle of monetary policy and its consequences will eventually conclude, stricter lending standards and increased regulatory oversight of the banking sector may just be beginning.

Opportunities across the private market sector

The current capital market landscape has left many investors feeling frustrated and uneasy. However, the private sector storyline does have reassuring elements, including still-sound market fundamentals (with a few exceptions, namely the office property type) and slowing construction starts in real estate. It is anticipated that private real estate asset values will hit bottom in 2024 as interest rates peak, presenting opportunities to engage in the new cycle at reevaluated price points. Within infrastructure, there is a significant demand for new infrastructure projects driven by themes of digitization, the need for energy generation, and transportation improvements.

For investors seeking more immediate opportunities, the debt markets offer a multitude of options to bridge the financing gaps left by a more constrained global banking sector. These opportunities encompass debt strategies in real estate, infrastructure, direct lending/private credit, and asset-backed securities. However, the windows for accessing debt at core or core-plus equity-like returns tend to be short-lived.

Investors with available capital to support project and entity-level recapitalization, cash infusion, and distressed asset purchases should thrive in the current environment. Factors favoring private equity investment include reduced competition, a slowdown in the pace of public offerings, and more reasonable purchase multiples. This trend also extends to real estate investment in the form of investments in real estate operating companies.

> "Investors should be prepared to **shift their focus to private equity real estate** as market conditions improve, anchoring their portfolios around structurally resilient property types and locations."

Investors should be prepared to shift their focus to private equity real estate as market conditions improve, anchoring their portfolios around structurally resilient property types and locations. These may include data centers, logistics facilities, apartments, life science properties, and student housing.

Client perspectives: Insights from our alternatives investments platform

Pension plans, the insurance sector, and a growing wealth sector are all turning to private capabilities as unique avenues to generate returns and mitigate risks.

On pension plans

Continued higher interest rates have made it more feasible for pension plans to help achieve critical actuarial return assumptions through public and private debt strategies. Alternative credit is a valuable complement to corporate debt within fixed income portfolios, providing higher risk-adjusted relative value, enhanced covenant protection, and superior structuring. A similar profile is observed in infrastructure debt. While real estate debt generally lacks substantial covenant protection, loans are being underwritten with significantly lower loan-to-value ratios and improved standards.

As inflation remains higher, inflation-sensitive investments are finding more appeal, and real returns are gaining a stronger position in benchmarking strategies. The "denominator effect" hasn't fully receded, and non-liquid investments are proving to be genuinely illiquid. This environment will likely continue to prompt pension funds to upgrade their holdings, managers, and strategic relationships to assure optimal liquidity potential.

Differentiated strategies and higher return opportunities will remain in high demand, particularly among larger plans seeking more direct and collaborative investment arrangements with their managers.

On insurance sector needs

Within the insurance sector, private debt alternatives are securing larger strategic portfolio allocations. Real estate debt remains a fixture in long-term allocations, while certain specialty strategies like construction lending are delivering attractive current values. Investments in direct lending and asset-backed securities are also highly regarded, with a particular emphasis on options that cater to both very short and very long durational needs.

On the developing wealth sector

Traditionally, private and alternative asset investments have been dominated by institutional investors, but the private wealth sector and retail investors now have an expanding array of opportunities. This new generation of vehicles is being managed by well-established institutions characterized by advanced management, strong governance, and strategies featuring more affordable fee structures.

Adjusting to higher-for-longer rates

Middle market direct lending stands to benefit

TIM WARRICK, CFA | Head of Alternative Credit

In 2023, tightening credit conditions, an uncertain economic environment, and declining enterprise value multiples slowed merger & acquisition and leveraged buyout (LBO) activity in the direct lending space. With fewer loan prepayments and refinancing activity and less natural deal flow from new LBOs, capital deployment for many lenders slowed significantly. Despite the slowing, middle market direct lending continued to fill the void left by commercial banks and the continued decline in syndicated loan market issuance.

> "While these trends are likely to play out further in 2024, investors have now **had over a year to embrace higher-for-longer interest rates**."

While these trends are likely to play out further in 2024, investors have now had over a year to embrace higher-for-longer interest rates. With less fear of "rate whiplash" and having had time to digest the denominator effect (the value of fixed rate instruments and equity falling in a correlated manner with rising rates), investor flows are likely to pick up considerably for middle market direct lending.

Although headwinds to the economy are expected, several supportive trends for middle market direct lending have an opportunity to enhance risk-adjusted returns relative to historic loan vintages.

- Increased focus on economically resilient business models: PE sponsor and lender focus will remain on the more cyclically resilient industries and borrowers that can generate steady financial performance through a cyclical downturn.
- More conservative leverage profile: Leverage expectations for sponsors and borrowers are considerably lower than levels targeted just a couple years ago in a much lower rate environment. Focus on the less competitive lower middle market borrower segment ($5-$15 million of EBITDA) can also provide the ability to set leverage levels below the broader middle market industry.
- Compelling valuation: Valuations remain attractive with not only the base SOFR rate remaining at a relatively high level, but the spread premium to public high yield loans is and will likely remain near the upper end of the range for much of the coming year.
- More lender friendly transaction terms: The structure of transactions should remain sound, with higher original issue discount, improved call protection, tighter financial covenants, and more conservative EBTIDA adjustments.
- Manageable default rates: Despite annual default rates potentially moving higher and approaching 3-4% for the private middle market, credit losses should remain in the 75-150 basis point range. In this scenario, the return to investors will be quite compelling, as the typical yield for performing first-lien, floating-rate middle market direct loans is over 12.5%.

Intentional industry exposure, coupled with disciplined credit structure, and a highly selective process to identify companies that exhibit steady performance through a down cycle, should result in more favorable risk-adjusted returns.

Private real estate equity

Attractive opportunities in resilient and niche sectors

JOHN BERG | Global Head of Private Real Estate

Private equity real estate generates returns through a combination of income and appreciation. With values falling, the current income component of return has become relatively more attractive compared to recent periods, generally in the range of 5-7%. Rents, particularly in sectors beyond offices, are expected to provide a reliable source of income due to healthy market fundamentals. Without the addition of appreciation, however, this level of return may not be as appealing as other investment options. Real estate investments will likely become more attractive once the Fed signals a pause or shift in monetary policy, resulting in lower yields for other asset classes and optimistic assumptions by real estate buyers, in turn increasing the likelihood of appreciation.

Irrespective of a potential Fed pivot, certain real estate strategies are expected to remain popular:

- From a diversified, multi-property sector perspective, funds that emphasize more resilient sectors like industrial and housing while reducing exposure to office should align well with investors' preferences.
- Single-sector strategies focusing on niche sectors with robust underlying fundamentals, such as data centers and manufactured housing, will likely attract capital.

Despite recent headwinds, investors who consider the potential for appreciation, favor resilient property sectors, and explore opportunities in niche sectors can find attractive options within private equity real estate.

Private real estate debt

A wall of maturities across the risk spectrum

CHRIS DUEY | Head of Private Debt Portfolio Management

Through its battle with inflation, the Fed has raised rates materially on the front end of the curve. In turn, the market has increased yields across the rest of the curve, significantly increasing the financing costs for the commercial real estate market.

The increase in the cost of capital has put pressure on commercial real estate valuations—especially office—and the availability of credit. While space market and property fundamentals are holding up reasonably well (absent office), the bar for financing is higher and the available liquidity is lower in today's market.

Although investment sales activity is off materially, there is a wall of maturities in 2024-2025 as loans come due into an environment of much higher interest rates, lower asset-level valuations, and tighter credit standards.

- For private debt investors, this is likely to create ample opportunities for attractive investments across the risk spectrum. Borrowing rates are at levels not seen in years, providing strong relative values compared to fixed income alternatives.
- For investors interested in the higher yielding space, so long as rates remain elevated and credit availability remains tight, providing financing to borrowers needing a recapitalization of their current capital structure will remain appealing.

REIT market outperformance?

A peak in long-term real yields often precedes growth

TODD KELLENBERGER | Client Portfolio Manager, Real Estate

Historically, the peak in long-term real yields is the catalyst for REIT market outperformance. When macro conditions get tough, REITs are often beneficiaries of investor rotation into risk assets that feature long-duration, defensive characteristics, and durable cash flows.

> "Notably, the valuations of public REITs have **corrected significantly since the Fed rate hike cycle** started and look attractive compared to broader equity markets."

Notably, the valuations of public REITs have corrected significantly since the Fed rate hike cycle started and look attractive compared to broader equity markets. Areas of concern for real estate, particularly office property types, are well-contained within REITs, as they generally possess high-quality balance sheets and minimal exposure to traditional U.S. office space.

Investors seeking exposure to the asset class should emphasize higher quality, demand resiliency, and exposure to structural growth drivers in light of the expected challenges in the broader macroeconomic landscape. Examples include:

- The non-traditional single-family rental sector, which has gained favor due to the prohibitively high costs of homeownership in the U.S.
- In healthcare, where senior housing enjoys demographic tailwinds of an aging U.S. population and low supply.
- Tower REITs, which are structurally benefiting from the long-term growth in mobile data usage and ever-increasing demand for mobile data services.

REITs that align with structural tailwinds are likely to see support in a climate where yields are peaking and there are expectations for attractive, above-average growth in cash flows.

Infrastructure stocks should benefit from companies' resilient fundamentals

Demand for essential services provides a consistent tailwind

EMILY FOSHAG , CFA | Portfolio Manager, Listed Infrastructure

Defensive stocks have borne the brunt of market fears over higher-for-longer rates in 2023, and listed infrastructure has been no exception. Notably, listed infrastructure now screens at historically cheap levels vs. global equities, creating a compelling entry point for investors to gain access to a fundamentally resilient asset class when the degree to which this rate hiking cycle will impact the economy remains uncertain.

Valuations matter

As infrastructure businesses are capital intensive, higher interest rates have had a modest impact on earnings. In fact, many market participants have revised valuations to reflect higher discount rates than assumed at the start of 2023. Heading into 2024, however, the magnitude of these headwinds is now more than reflected in the valuations of many listed infrastructure companies.

Listed infrastructure valuations generally reflect the current macroeconomic backdrop more than unlisted infrastructure valuations, and recent relative performance supports this hypothesis. While the long-term return drivers of listed infrastructure closely mirror those of unlisted infrastructure strategies and, as such, long-term investment returns have been comparable, listed infrastructure returns have trailed since early 2020. This underperformance is unlikely to persist indefinitely. When listed infrastructure has meaningfully underperformed comparable unlisted assets in prior periods, private equity infrastructure buyers have taken advantage of the price dislocation in the public markets and paid significant premiums in take-private transactions.

Resilient fundamentals

In 2024, infrastructure stocks should benefit from the companies' resilient fundamentals as economic growth slows and will be especially well-positioned should slowing growth coincide with unanticipated economic shocks or sharp downward pressure on bond yields.

Structural demand and sustainable focus

Infrastructure businesses deliver essential services, the demand for which is relatively insensitive to economic cycles. These companies also play a dominant role in supporting global sustainability agendas and are making critical investments in driving environmental, social, and economic progress. As a result, infrastructure businesses enjoy numerous contractual and regulatory protections that enable them to operate from positions of financial strength in various macroeconomic environments.

Structural growth drivers for listed infrastructure companies—such as the clean energy transition, demographic shifts, and technological innovation—will likely remain tailwinds in the period ahead and are positioned to meaningfully outlast today's macro concerns.

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