Principal Global Investors

Morley Capital Management

Economic and market review

3Q 2021 | As of September 30, 2021

Morley Capital Management (Morley), a specialized investment boutique of Principal Global Fixed Income.

Key themes for 4Q 2021

- Resumption of cyclical economic recovery/reopening expected to drive growth
  - Possibility of COVID fifth wave a persistent risk
- Persistent inflationary pressures may challenge transitory narrative
- Financial conditions remain easy even as policy normalization begins
- With market angst heightened, expectations for greater volatility in financial markets
- Impact of YTD negative returns on fixed income flows

What impact have we seen on global index returns?

The S&P 500 Index beat the Bloomberg U.S. Agg. Bond Index for the sixth consecutive quarter

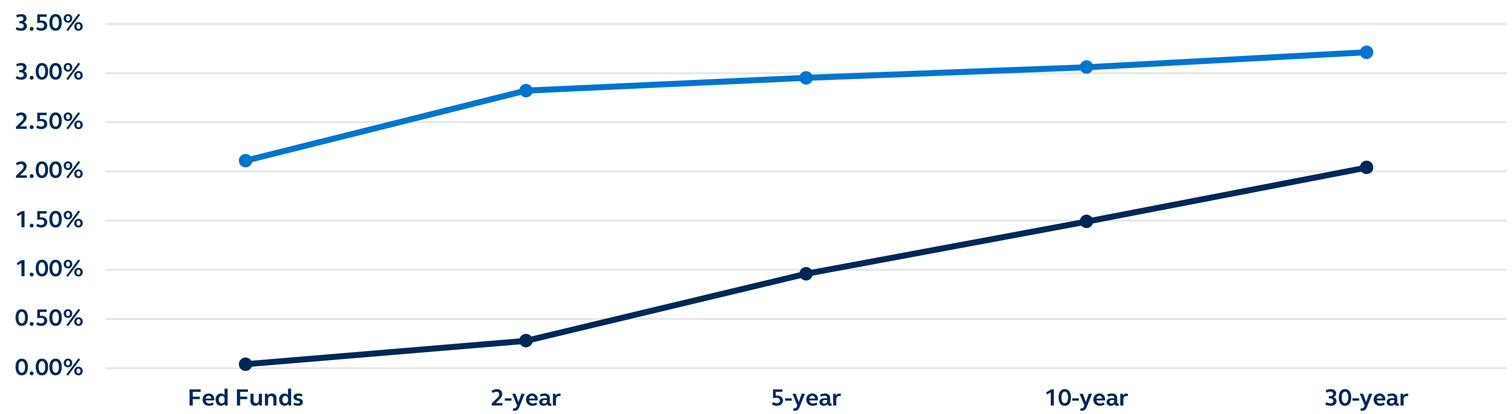
	3-months	YTD	1-year	3-year	5-year	10-year
Fixed Income						
ICE BofA U.S. Treasury Bill 3-month Index	0.01%	0.04%	0.07%	1.18%	1.16%	0.63%
Bloomberg Aggregate Bond Index	0.05%	-1.55%	-0.90%	5.36%	2.94%	3.01%
Bloomberg U.S. Corp High Yld 2% Issuer Capped Index	0.89%	4.54%	11.27%	6.89%	6.50%	7.42%
Bloomberg Long-Term Govt/Credit Index	0.04%	-1.93%	-1.13%	5.94%	3.24%	3.24%
U.S. Equities						
Russell 1000 Value Index	-0.78%	16.14%	35.01%	10.07%	10.94%	13.51%
S&P 500 Index	0.58%	15.92%	30.00%	15.99%	16.90%	16.63%
Russell 1000 Growth Index	1.16%	14.30%	27.32%	22.00%	22.84%	19.68%
Russell Midcap Index	-0.93%	15.17%	38.11%	14.22%	14.39%	15.52%
Russell 2000 Index	-4.36%	12.41%	47.68%	10.54%	13.45%	14.63%
Non-U.S. Equities						
MSCI EAFE NTR Index	-0.45%	8.35%	25.73%	7.62%	8.81%	8.10%
MSCI ACWI ex-USA Index	-2.99%	5.90%	23.92%	8.03%	8.94%	7.48%
MSCI Emerging Markets Index	-8.09%	-1.25%	18.20%	8.58%	9.23%	6.09%
Other						
MSCI U.S. REIT Index	0.75%	22.15%	35.77%	8.82%	5.55%	9.88%
S&P GSCI® Index	5.22%	38.27%	58.30%	-1.49%	3.64%	-4.83%
U.S. Dollar Index	2.01%	4.00%	-1.03%	-0.51%	-0.30%	1.68%

As of 9/30/2021
Source: FactSet. Returns are annualized. **Past performance does not guarantee future results**. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index. See Important Information for index descriptions.

The history of interest rates

How have interest rates changed in recent years?

	Sept. 30, 2018	Sept. 30, 2019	Sept. 30, 2020	Sept. 30, 2021
2-year	2.82%	1.62%	0.13%	0.28%
5-year	2.95%	1.54%	0.28%	0.96%
10-year	3.06%	1.66%	0.68%	1.49%
2- to 10-year spread	0.24%	0.04%	0.56%	1.21%
30-year	3.21%	2.11%	1.46%	2.04%



	Fed Funds	2-year	5-year	10-year	30-year
Sept. 30, 2021	0.04%	0.28%	0.96%	1.49%	2.04%
Sept. 28, 2018	2.11%	2.82%	2.95%	3.06%	3.21%

Source: FactSet. **Past performance does not guarantee future results.**

Asset Class Returns as of September 30, 2021

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD
Best	Real Estate 28.60%	Government Treasury 29.93%	Emerging Markets 18.23%	Small Cap 38.82%	Real Estate 31.78%	Real Estate 4.23%	Small Cap 21.31%	Emerging Markets 37.28%	Cash 1.86%	Large Cap 31.49%	Small Cap 19.96%	Commodities 29.13%
	Small Cap 26.85%	Real Estate 9.24%	Mid Cap 17.88%	Mid Cap 33.50%	Government Treasury 25.07%	Large Cap 1.38%	Mid Cap 20.74%	Intl Stocks 25.03%	Intermediate Bond 0.01%	Mid Cap 26.20%	Large Cap 18.40%	Real Estate 24.79%
	Mid Cap 26.64%	Intermediate Bond 7.84%	Real Estate 17.59%	Large Cap 32.39%	Large Cap 13.69%	Asset Allocation 1.28%	High Yield 17.34%	Large Cap 21.83%	Intl Bonds -1.66%	Real Estate 25.76%	Emerging Markets 18.31 %	Large Cap 15.92%
	Emerging Markets 18.88%	Intl Bonds 5.93%	Intl Stocks 17.32%	Intl Stocks 22.78%	Asset Allocation 10.62%	Intermediate Bond 0.55%	Large Cap 11.96%	Mid Cap 16.24%	Government Treasury -1.84%	Small Cap 25.53%	Government Treasury 17.70%	Mid Cap 15.52%
	Commodities 16.83%	Asset Allocation 4.69%	Small Cap 16.35%	Asset Allocation 17.56%	Mid Cap 9.77%	Cash 0.03%	Commodities 11.77%	Small Cap 14.65%	High Yield -2.26%	Asset Allocation 22.18%	Asset Allocation 14.73%	Small Cap 12.41%
	High Yield 15.24%	High Yield 4.50%	Large Cap 16.00%	High Yield 7.38%	Intermediate Bond 5.97%	Intl Stocks -0.81%	Emerging Markets 11.19%	Asset Allocation 14.21%	Asset Allocation -2.35%	Intl Stocks 22.01%	Mid Cap 13.66%	Asset Allocation 8.71%
	Large Cap 15.06%	Large Cap 2.11%	High Yield 15.44%	Real Estate 1.86%	Small Cap 4.89%	Government Treasury -1.21%	Asset Allocation 8.31%	Intl Bonds 9.92%	Large Cap -4.38%	Emerging Markets 18.44 %	Intl Bonds 10.52%	Intl Stocks 8.35%
	Asset Allocation 12.13%	Cash 0.06%	Asset Allocation 11.31%	Cash 0.06%	High Yield 2.44%	Mid Cap -2.18%	Real Estate 7.24%	Government Treasury 8.53%	Real Estate -4.84%	Government Treasury 14.83%	Intl Stocks 7.82%	High Yield 4.55%
	Government Treasury 9.38%	Mid Cap -1.73%	Intermediate Bond 4.21%	Intermediate Bond -2.02%	Cash 0.02%	Small Cap -4.41%	Intermediate Bond 2.65%	High Yield 7.48%	Small Cap -11.01%	High Yield 14.40%	Intermediate Bond 7.51%	Cash 0.03%
	Intl Stocks 7.75%	Small Cap -4.18%	Government Treasury 3.56%	Emerging Markets -2.60%	Emerging Markets -2.19%	High Yield -4.55%	Intl Bonds 1.86%	Real Estate 4.18%	Mid Cap -11.08%	Intermediate Bond 8.72%	High Yield 6.20%	Emerging Markets -1.25%
	Intl Bonds 6.78%	Intl Stocks -12.14%	Intl Bonds 0.85%	Intl Bonds -5.06%	Intl Bonds -2.53%	Intl Bonds -4.84%	Government Treasury 1.33%	Intermediate Bond 3.54%	Commodities -11.25%	Commodities 7.69%	Cash 0.58%	Intermediate Bond -1.55%
	Intermediate Bond 6.54%	Commodities -13.32%	Cash 0.09%	Commodities -9.52%	Intl Stocks -4.90%	Emerging Markets -14.92%	Intl Stocks 1.00%	Commodities 1.70%	Intl Stocks -13.79%	Intl Bonds 5.23%	Commodities -3.12%	Government Treasury -7.49%
Worst	Cash 0.10%	Emerging Markets -18.42%	Commodities -1.06%	Government Treasury -12.66%	Commodities -17.01%	Commodities -24.66%	Cash 0.27%	Cash 0.84%	Emerging Markets -14.58%	Cash 2.25%	Real Estate -7.90%	Intl Bonds -7.86%

The returns above reflect performance of certain indexes as defined below. This information is general in nature and is not intended to be reflective of any specific plan. Cash- FTSE 3 month T-bill ,Government Treasury-Bloomberg Long Treasury, Commodities-Bloomberg Commodity Idx, Intermediate Bond-Bloomberg US Agg Bond Idx, High Yield Bond-ICE BofAML High Yield Idx, Intl Bonds-JPMorgan GBI Global ex U.S., Asset Allocation-portfolio assumes the following weights: 60% S&P 500 and 40% Bloomberg US Agg, Large Cap-S&P 500, Mid Cap - S&P Midcap 400, Small Cap-Russell 2000, Intl Stocks-MSCI EAFE (net), Emerging Markets-MSCI EM (net), Real Estate-Wilshire U.S. REIT. **Past performance does not guarantee future results.**

The ebbs and flows of a post-pandemic global economy

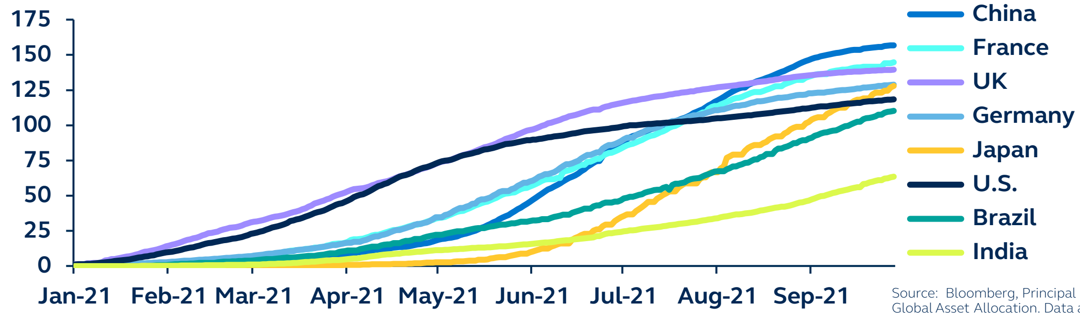
Throughout the pandemic, vaccinations have been key to lifting social restrictions and, therefore, local market performance. In the United States and Europe, where the S&P 500 and Eurostoxx 600 are up 15.9% and 14.0% year-to-date respectively, early and aggressive vaccination rollouts have allowed for full reopening of their economies. Yet, additional significant boosts from vaccination momentum are unlikely and, coupled with policy stimulus giving way to policy normalization, both U.S. and European growth rates have likely peaked.

In contrast, EM equities have struggled since early 2021, as lagging vaccinations, ongoing COVID-19 outbreaks, and start/stop restrictions dampened economic activity. However, several EM countries have recently accelerated their pace of vaccination and should soon reach levels that trigger a reawakening in activity.

Insight: Rising vaccination rates in EM should permit the reopening theme to transfer from DM to EM—provided China's economy achieves a soft landing.

COVID-19 vaccination rollout

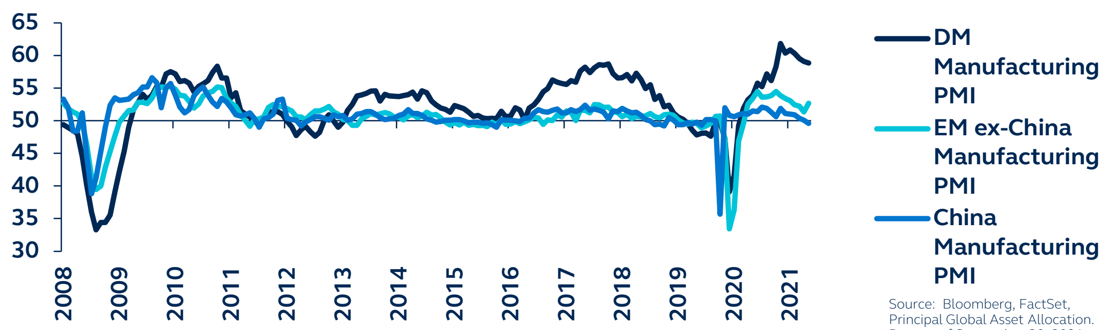
Total vaccine doses administered per hundred people, January 2021 – present



Source: Bloomberg, Principal Global Asset Allocation. Data as of September 30, 2021.

PGAA GDP-weighted Purchasing Manager Indices (PMI)

Index level, May 2008 – present



Source: Bloomberg, FactSet, Principal Global Asset Allocation. Data as of September 30, 2021.

Inflation is transitory—but still deserves investor caution

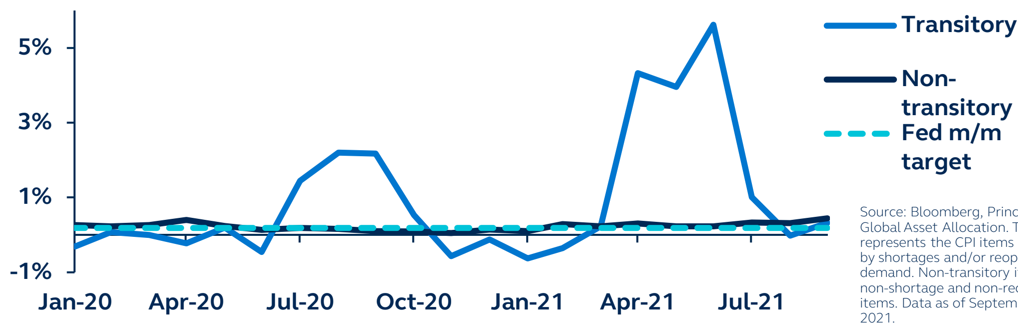
Elevated global inflation prints are largely being driven by reopening demand and supply shortages—but both factors are unsustainable, and the easing of these dynamics should prompt a reversal of the recent price pressures. As we expect it will take well into 2022 for supply chains to fully normalize, core goods prices may remain elevated through much of next year.

There are fears that if transitory shocks are prolonged, inflation expectations will become de-anchored, and inflation will then become more persistent. Market-based measures show DM long-term inflation expectations are still well-behaved, hovering close to central bank inflation targets, but household survey-based inflation expectations are signalling greater concern and deserve a watchful eye—particularly with regards to a potential purchasing power squeeze from higher energy prices. At the same time, shelter prices have recently surged and may signal a concerning development in underlying inflation pressures.

Insight: Inflation is most likely transitory—but market fall-out would still be significant if elevated prices begin to meaningfully dampen consumer demand.

Transitory CPI versus non-transitory CPI

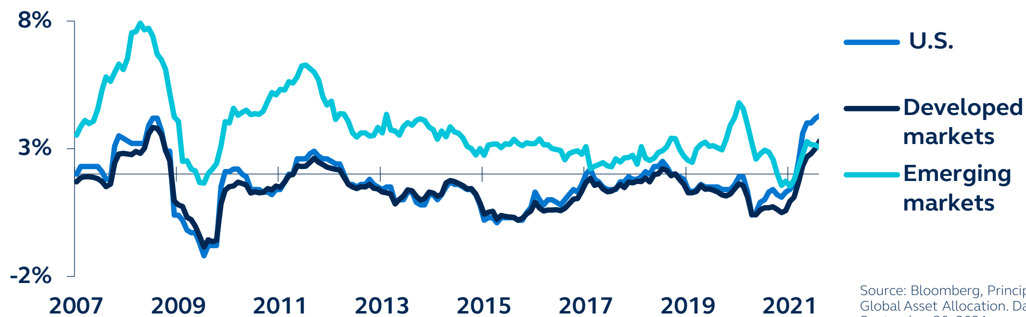
Non-annualized month-over-month, January 2020 – present



Source: Bloomberg, Principal Global Asset Allocation. Transitory represents the CPI items impacted by shortages and/or reopening demand. Non-transitory items are non-shortage and non-reopening items. Data as of September 30, 2021.

PGAA GDP-weighted Inflation

2007 – present



Source: Bloomberg, Principal Global Asset Allocation. Data as of September 30, 2021.

Maximum employment goal is key for Fed action

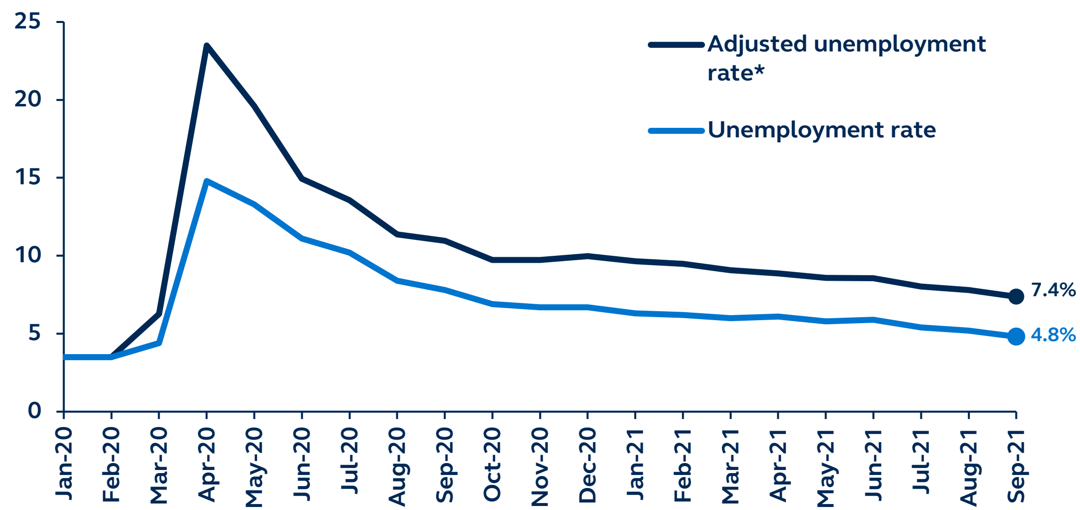
Unlike inflation, labor market recoveries are still incomplete. The U.S unemployment rate has dropped significantly, but it understates the degree of economic distress. The participation rate is stuck 1.5–2 ppt below pre-COVID levels: Over 3 million people still haven't returned to the U.S. labor force. Approaching the labor market as the Fed does, restricting the participation rate to its pre-pandemic level and considering COVID-19 related misclassifications, the adjusted headline unemployment rate is actually closer to 7.5% instead of 4.8%.

With such tight labor supply, U.S. wage inflation is a risk. But the U.S. employment cost index and the Fed's favored Atlanta Wage Growth Tracker show little evidence of worrying wage increases. We look for an increase in labor participation in 4Q because of the expiration of unemployment benefits and return of in-person schooling. Rising labor supply should stave off inflationary implications from a low unemployment rate; if not, margin compression will be a risk.

Insight: Without a recovery in participation, the labor market recovery will be incomplete and wage pressures will pose a risk to profit margins.

U.S. unemployment rates

January 2020 – present



Source: Bureau of Labor Statistics, Principal Global Investors. *Adjusted unemployment holds the participation rate at February 2020 level of 63.3% and expands the classification of unemployed to include misclassified workers and the monthly change in labor force. Data as of September 30, 2021.

Central bank support continues to buoy developing markets

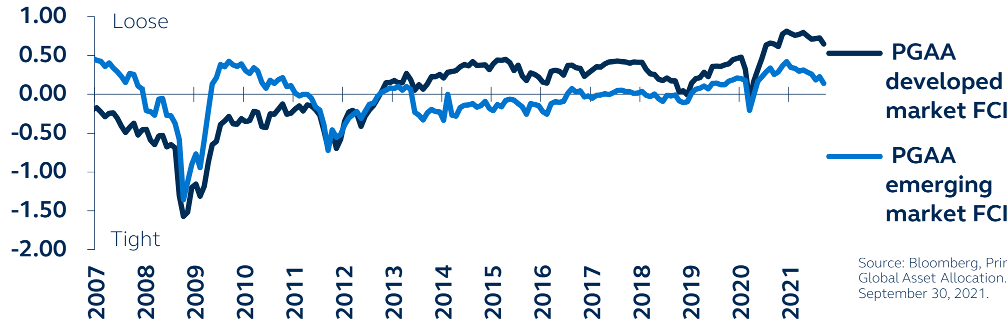
The key message from most DM central banks is continued movement toward dialling back monetary stimulus, while also emphasizing that policy will still be accommodative. The Fed has clearly signalled that it is set to begin tapering asset purchases imminently, likely at a pace of $15bn per month, ending in mid-2022. Yet, with the labor market recovery still having some way to go, we don't envisage Fed lift-off until 2Q 2023. Other major DM central banks, such as the European Central Bank (ECB) and the Bank of Japan (BOJ), face slower GDP growth trajectories and long-term inflation expectations remain below central bank targets. As a result, they are even further behind in the normalization process and policy rate lift-off for them may not take place until 2025.

While DM financial conditions have tightened, the slow steps to lift-off is keeping them near record highs and very loose by historical comparison. By contrast, with many EM central banks already raising rates in response to inflationary pressures, they face relatively tighter financial conditions.

Insight: Although DM central banks are now turning their attention to policy normalization, progress will be slow, keeping financial conditions loose and supporting risk assets.

Developing market and emerging market financial conditions

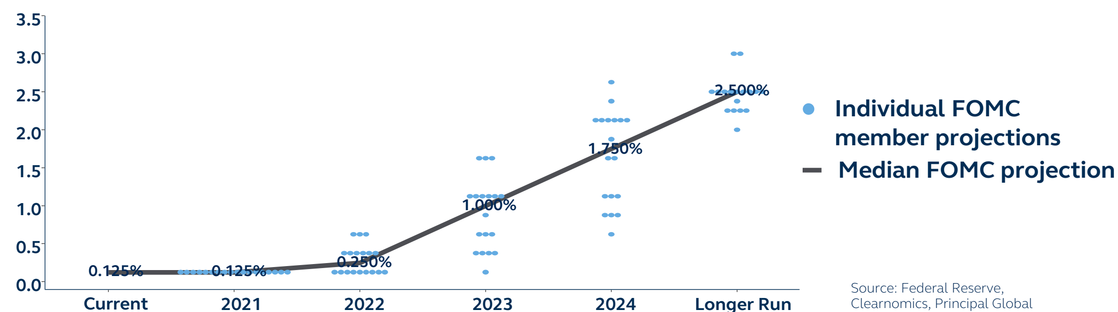
Z-score, 2007 - present



Source: Bloomberg, Principal Global Asset Allocation. Data as of September 30, 2021.

FOMC federal funds rate dot plot

Individual and median projections, percent



Source: Federal Reserve, Clearnomics, Principal Global Investors. Data as of September 30, 2021.

Rates are too low, but the path to higher rates should be smooth

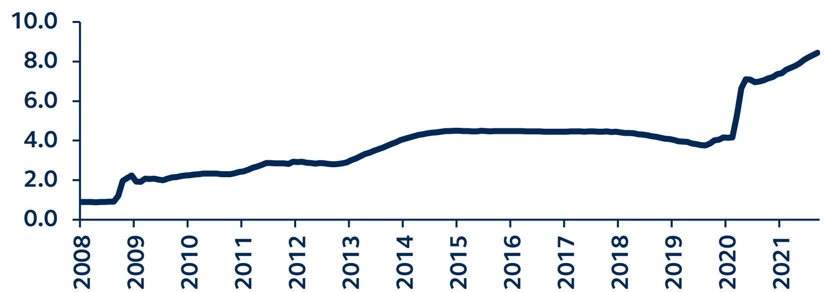
Although the Fed shift towards tapering and sustained inflationary pressures generated a sell-off in global bond markets in late 3Q, 10-year U.S. Treasury yields remain expensive relative to fair value and the bias is still towards gradually higher rates.

Yet the path to higher yields is unlikely to be either sharp or disruptive. Although the Fed has turned its attention to normalization, tapering implies that the balance sheet will continue to expand at least until mid-2022 and with fundamentals still strong, markets should be able to digest the move higher. There's also a limit to how high and fast rates can go. Other developed market central banks, such as the ECB and BOJ, are still years behind the Fed in the normalization process and their yields will likely remain relatively depressed. These global bond substitutes should introduce a natural resistance for U.S. yields.

Insight: Don't expect Taper Tantrum 2.0. Policy normalization is almost fully priced-in and the path to higher rates should be neither sharp nor disruptive.

U.S. Fed balance sheet

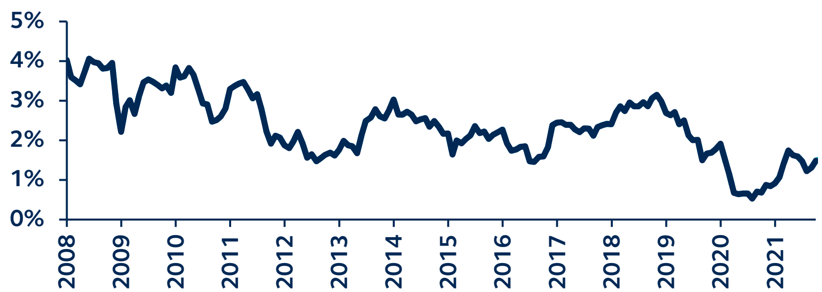
USD trillions, 2008 – present



Source: Bloomberg, Principal Global Asset Allocation. Data as of September 30, 2021.

U.S. 10-year treasury yield

2008 – present



Source: Bloomberg, Principal Global Asset Allocation. Data as of September 30, 2021.

Focus on the carry in fixed income credit market

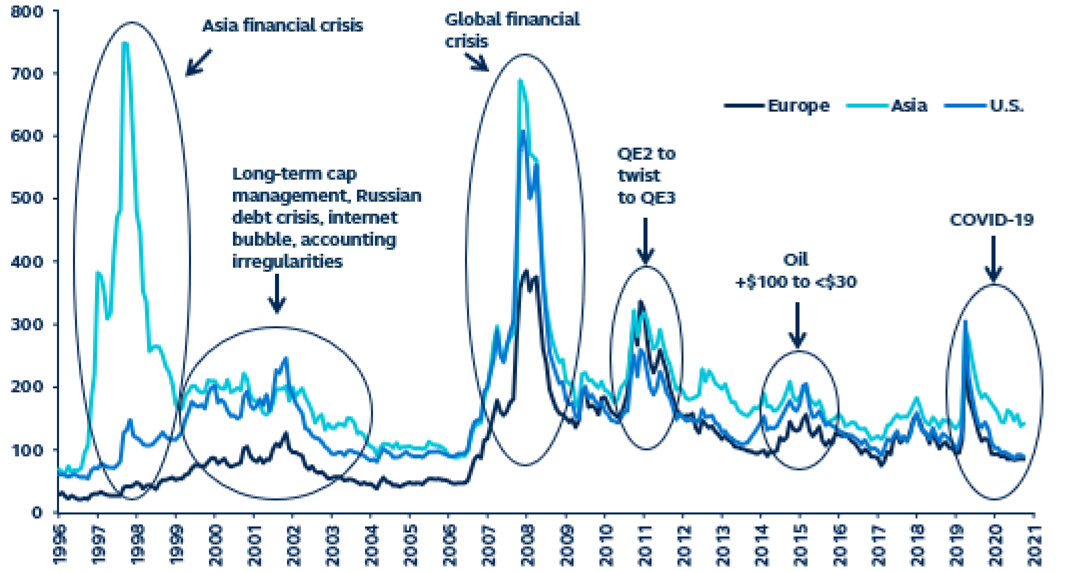
Despite the market turbulence over the past quarter, credit has remained extremely resilient and stable. Investment grade credit spreads in the U.S. and Europe sit close to record tights, while Asia investment grade spreads have largely shrugged off China's regulatory clampdowns and the Evergrande fallout.

Looking forward, while fundamentals are slightly weaker than in recent quarters, the still solid economic backdrop should support spreads remaining close to their current levels. Yet, at these record tights, the potential for further spread compression is limited, especially in the U.S. and Europe. With these dynamics at play, investment grade credit returns will likely be largely driven by carry. We see greater upside in other segments of core fixed income, particularly those that are more cushioned against rising rates.

Insight: While investment grade credit has remained resilient in the face of growing market challenges, returns will only be driven by carry.

Historical investment grade spreads by region

Basis points (bps), December 31, 1996 – present



Source: Bloomberg, Principal Global Asset Allocation. See disclosures for index descriptions. Data as of September 30, 2021.

Important information

Index descriptions

Bloomberg Barclays U.S. Corporate Investment Grade Index includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity and quality requirements. To qualify, bonds must be SEC-registered. The corporate sectors are industrial, utility and finance, which include both US and non-US corporations.

Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

ICE BofA Asian Dollar Investment Grade Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in Asian domestic markets (China, Hong Kong, South Korea, Indonesia, India, Singapore, Malaysia, Thailand, Taiwan, Macau, and Philippines).

ICE BofA Euro Corporate Index tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets.

MSCI AC Asia ex Japan Index captures large and mid cap representation across 2 of 3 Developed Markets (DM) countries (excluding Japan) and 9 Emerging Markets (EM) countries in Asia.

MSCI AC Asia Pacific Index captures large and mid cap representation across 5 Developed Markets countries and 9 Emerging Markets countries in the Asia Pacific region.

MSCI ACWI Index includes large and mid cap stocks across developed and emerging market countries.

MSCI Brazil Index is designed to measure the performance of the large and mid cap segments of the Brazilian market.

MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g., ADRs).

MSCI EAFE Index is listed for foreign stock funds (EAFE refers to Europe, Australia, and Far East). Widely accepted as a benchmark for international stock performance, the EAFE Index is an aggregate of 21 individual country indexes.

MSCI Emerging Markets Index consists of large and mid cap companies across 24 countries and represents 10% of the world market capitalization. The index covers approximately 85% of the free float-adjusted market capitalization in each country in each of the 24 countries.

MSCI Europe Index captures large and mid cap representation across 15 Developed Markets (DM) countries in Europe.

MSCI Germany Index is designed to measure the performance of the large and mid cap segments of the German market.

MSCI India Index is designed to measure the performance of the large and mid cap segments of the Indian market.

MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market.

MSCI Russia Index is designed to measure the performance of the large and mid cap segments of the Russian market.

MSCI United Kingdom Index is designed to measure the performance of the large and mid cap segments of the UK market.

MSCI USA Growth Index captures large and mid cap securities exhibiting overall growth style characteristics in the US. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

MSCI USA Index is a market capitalization weighted index designed to measure the performance of equity securities in the top 85% by market capitalization of equity securities listed on stock exchanges in the United States.

MSCI USA Large Cap Index is designed to measure the performance of the large cap segments of the US market.

MSCI USA Mid Cap Index is designed to measure the performance of the mid cap segments of the US market.

Important information

Index definitions

SCI USA Quality Index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage. The MSCI Quality Indexes complement existing MSCI Factor Indexes and can provide an effective diversification role in a portfolio of factor strategies.

MSCI USA Small Cap Index is designed to measure the performance of the small cap segment of the US equity market.

MSCI USA Value Index captures large and mid cap US securities exhibiting overall value style characteristics. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

Russell 1000® Index measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership.

Standard & Poor's 500 Index is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market.

STOXX Europe 600 Index, with a fixed number of 600 components, represents large, mid and small capitalization companies across 17 countries of the European region.\

Market indices have been provided for comparison purposes only. They are unmanaged and do not reflect any fees or expenses. Individuals cannot invest directly in an index.

Risk considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Asset allocation and diversification do not ensure a profit or protect against a loss. Equity investments involve greater risk, including higher volatility, than fixed-income investments. Fixed-income investments are subject to interest rate risk; as interest rates rise their value will decline. International and global investing involves greater risks such as currency fluctuations, political/social instability and differing accounting standards. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk.

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