Principal Morley

Principal Asset Management℠

Economic and market review

Principal Asset Allocation Viewpoints

As of March 31, 2024

Q2 2024 key themes

The U.S. economy stands out from the crowd.
U.S. growth appears to be downshifting somewhat as lower-income households pull back and corporates face higher refinancing costs. But with most other global economies still struggling, the U.S. will likely remain the strongest global performer.

Global disinflation is showing signs of stalling.
After having made significant progress last year, inflation deceleration has flattened out. The last mile of disinflation toward central bank targets will require some economic slowdown and job market rebalancing and will take time.

Central banks believe they can cut rates without sacrificing inflation.
We would expect global central banks to start easing sometime this year. The Bank of England and ECB are likely to lead the way with the Fed following later.

Fixed income yields are attractive compared to equity yields.
U.S. Treasury yields should skew lower as the Fed cuts but will be limited by the shallow easing cycle. Credit spreads are tight but, providing recession is avoided, should not widen significantly and provide important carry opportunities.

With potential gains across asset classes, staying in cash is the main risk.
Assets in money market funds have ballooned to a record $6 trillion, with investors attracted by elevated yields. Now, with rate cuts on the near-term horizon, this cash may represent a potential tailwind to risk assets.

Equities continued the strong momentum from Q4 2023 into Q1 2024

Core bonds delivered a negative return for the quarter as long and intermediate rates increased

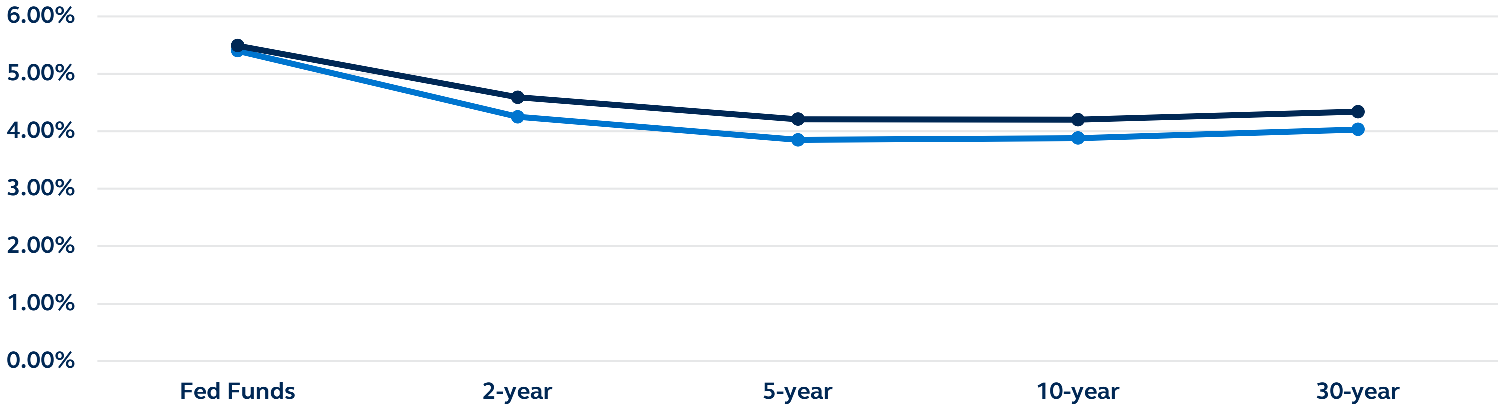
	3-month	1-year	3-year	5-year	10-year
Fixed Income					
ICE BofA U.S. Treasury Bill 3-month Index	1.29%	5.24%	2.58%	2.02%	1.38%
Bloomberg Aggregate Bond Index	-0.78%	1.70%	-2.46%	0.36%	1.54%
Bloomberg U.S. Corp High Yld 2% Issuer Capped Index	1.47%	11.15%	2.19%	4.19%	4.44%
Bloomberg Long-Term Govt/Credit Index	-2.41%	-1.15%	-6.04%	-0.62%	2.32%
U.S. Equities					
Russell 1000 Value Index	8.99%	20.27%	8.11%	10.32%	9.01%
S&P 500 Index	10.56%	29.88%	11.49%	15.05%	12.96%
Russell 1000 Growth Index	11.41%	39.00%	12.50%	18.52%	15.98%
Russell Midcap Index	8.60%	22.35%	6.07%	11.10%	9.95%
Russell 2000 Index	5.18%	19.71%	-0.10%	8.10%	7.58%
Non-U.S. Equities					
MSCI EAFE NTR Index	5.78%	15.32%	4.78%	7.33%	4.80%
MSCI ACWI ex-USA Index	4.69%	13.26%	1.94%	5.97%	4.25%
MSCI Emerging Markets Index	2.37%	8.15%	-5.05%	2.22%	2.95%
Other					
MSCI U.S. REIT Index	-0.62%	8.96%	2.84%	2.93%	5.25%
S&P GSCI® Index	10.36%	11.14%	18.05%	7.83%	-2.93%
U.S. Dollar Index	3.17%	1.99%	3.89%	1.45%	2.70%

As of March 31, 2024.
Source: Mstar Direct. 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?

	March 31, 2021	March 31, 2022	March 31, 2023	Dec. 31, 2023	March 31, 2024
Fed Funds	0.01	0.17	4.74	5.40	5.49
2-year	0.16	2.28	4.06	4.25	4.59
5-year	.92	2.42	3.60	3.85	4.21
10-year	1.74	2.32	3.48	3.88	4.20
2- to 10-year spread	1.58	0.04	-0.58	-0.37	-0.39
30-year	2.41	2.44	3.67	4.03	4.34



	Fed Funds	2-year	5-year	10-year	30-year
March 31, 2024	5.49%	4.59%	4.21%	4.20%	4.34%
December 31, 2023	5.40%	4.25%	3.85%	3.88%	4.03%

Source: Mstar Direct. **Past performance does not guarantee future results.**

ASSET CLASS RETURNS AS OF MARCH 31, 2024

Best

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	YTD
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%	Real Estate 46.18%	Commodities 16.09%	Large Cap 26.29%	Large Cap 10.56%
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%	Large Cap 28.71%	Cash 1.50%	Intl Stocks 18.24%	Mid Cap 9.95%
Large Cap 32.39%	Large Cap 13.69%	Asset Allocation 1.28%	High Yield 17.34%	Large Cap 21.83%	Government Treasury -1.84%	Real Estate 25.76%	Emerging Markets 18.31%	Commodities 27.11%	High Yield -11.11%	Asset Allocation 17.67%	Asset Allocation 5.94%
Intl Stocks 22.78%	Asset Allocation 10.62%	Intermediate Bond 0.55%	Large Cap 11.96%	Mid Cap 16.24%	Intl Bonds -2.15%	Small Cap 25.53%	Government Treasury 17.70%	Mid Cap 24.76%	Intermediate Bond -13.01%	Small Cap 16.93%	Intl Stocks 5.78%
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%	Asset Allocation 15.86%	Mid Cap -13.06%	Mid Cap 16.44%	Small Cap 5.18%
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%	Small Cap 14.82%	Intl Stocks -14.45%	Real Estate 16.10%	Emerging Markets 2.37%
Real Estate 1.86%	Small Cap 4.89%	Government Treasury -1.21%	Asset Allocation 8.31%	Intl Bonds 10.51%	Large Cap -4.38%	Emerging Markets 18.44%	Intl Bonds 10.11%	Intl Stocks 11.26%	Asset Allocation -15.79%	High Yield 13.40%	Commodities 2.19%
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 5.29%	Large Cap -18.11%	Emerging Markets 9.83%	High Yield 1.46%
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 0.05%	Intl Bonds -18.70%	Intermediate Bond 5.53%	Cash 1.37%
Emerging Markets -2.60%	Emerging Markets -2.19%	High Yield -4.55%	Intl Bonds 1.49%	Real Estate 4.18%	Mid Cap -11.08%	Intermediate Bond 8.72%	High Yield 6.20%	Intermediate Bond -1.54%	Emerging Markets -20.09%	Cash 5.26%	Real Estate -0.01%
Intl Bonds -3.08%	Intl Bonds -3.08%	Intl Bonds -6.02%	Government Treasury 1.33%	Intermediate Bond 3.54%	Commodities -11.25%	Commodities 7.69%	Cash 0.58%	Emerging Markets -2.54%	Small Cap -20.44%	Intl Bonds 3.99%	Intermediate Bond -0.78%
Commodities -9.52%	Intl Stocks -4.90%	Emerging Markets -14.92%	Intl Stocks 1.00%	Commodities 1.70%	Intl Stocks -13.79%	Intl Bonds 5.09%	Commodities -3.12%	Government Treasury -4.65%	Real Estate -26.81%	Government Treasury 3.06%	Intl Bonds -3.21%
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 -7.05%	Government Treasury -29.26%	Commodities -7.91%	Government Treasury -3.26%

Worst

The returns 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-BBg Long Treasury, Commodities-Bloomberg Commodity Idx, Intermediate Bond-BBg US Agg Bond Idx, High Yield Bond-ICE BofA High Yield Idx, Intl Bonds-JPMorgan GBI Global ex U.S., Asset Allocation-portfolio assumes the following weights: 60% S&P 500 and 40% BBg 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.

Global economy: U.S. stands out from the crowd

The U.S. economy has withstood the most aggressive central bank rate hiking cycle in four decades and continues to grow strongly, overshadowing other major global economies.

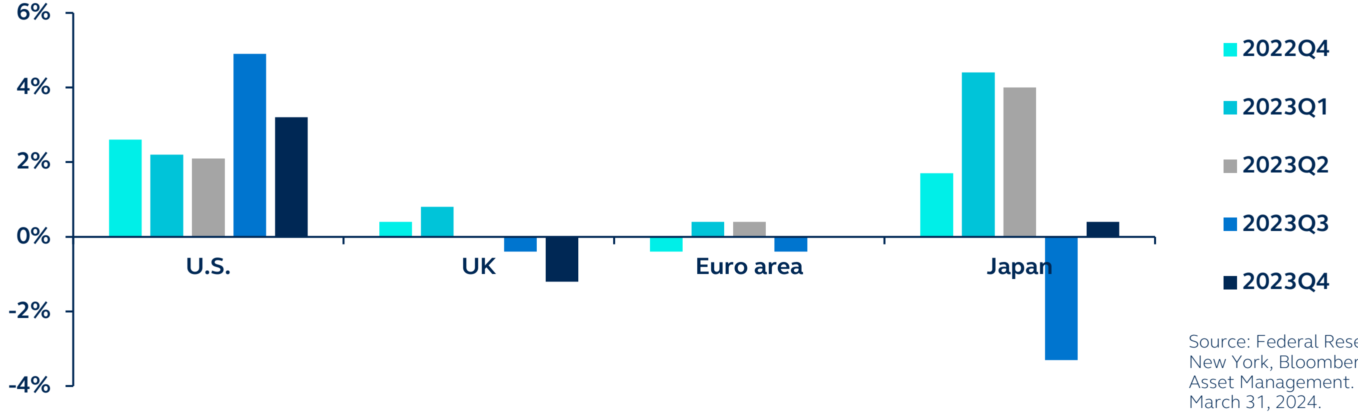
In the second half of 2023, the U.S. economy posted an average quarterly GDP growth rate of 4.1%. By contrast, the UK entered technical recession, while the Euro area remained entrenched in stagnation. China has continued to struggle, weighed down by depressed household confidence, which has been exacerbated by entrenched property market weakness. Furthermore, deflation means that financial conditions are tightening even as authorities cut policy rates.

Looking forward, China is unlikely to hit its 5% growth target without new, impactful stimulus measures, and while policymakers clearly recognize this, they continue to be held back by debt and leverage concerns. Europe is seeing signs of a cyclical upturn in the manufacturing cycle and should avoid recession, while Japan's reflation story has legs. U.S. growth is set to downshift over the coming quarters as consumers pull back slightly, the labor market rebalances, and corporates finally confront higher refinancing costs. But overall, growth will likely only slow to trend, with 2024 marking another year of U.S. economic outperformance.

The U.S. appears to be set to outperform its global peers once again. While Europe and China struggle to make significant headway, the U.S. economy is heading toward a soft landing.

Global growth

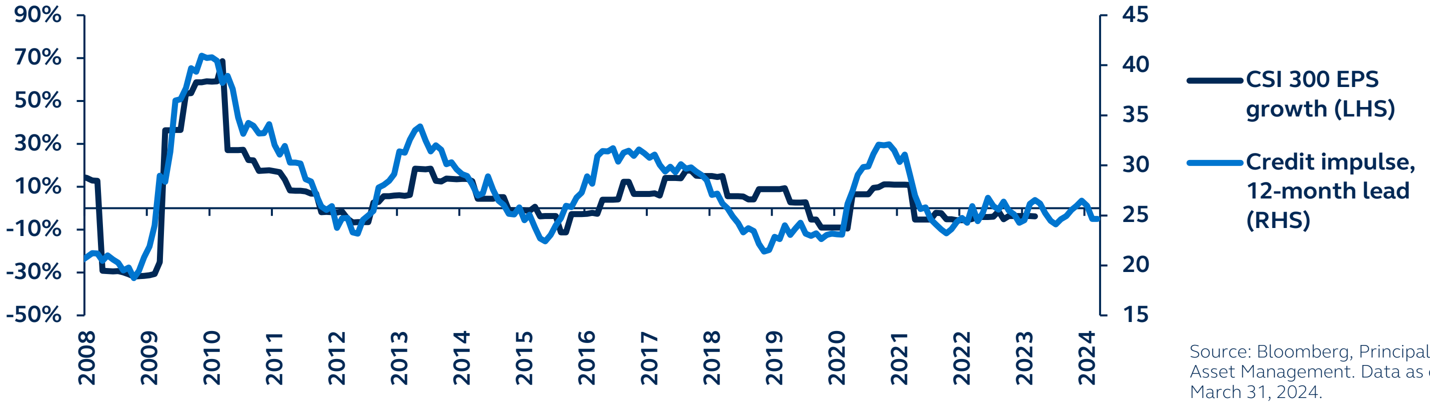
Quarterly, 4Q 2022–4Q 2023



Source: Federal Reserve Bank of New York, Bloomberg, Principal Asset Management. Data as of March 31, 2024.

China credit impulse versus earnings growth

2008–present



Source: Bloomberg, Principal Asset Management. Data as of March 31, 2024.

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U.S. economy halfheartedly confronting higher rates

The U.S. economy's interest rate sensitivity is considerably lower than in previous hiking cycles, largely because many households insulated themselves from higher policy rates by locking in the 2020/2021 record low mortgage rates. So even as rising Fed policy rates drove 30-year mortgage rates to 8% last year, the effective rate on the outstanding stock of mortgage debt remained at around 3%.

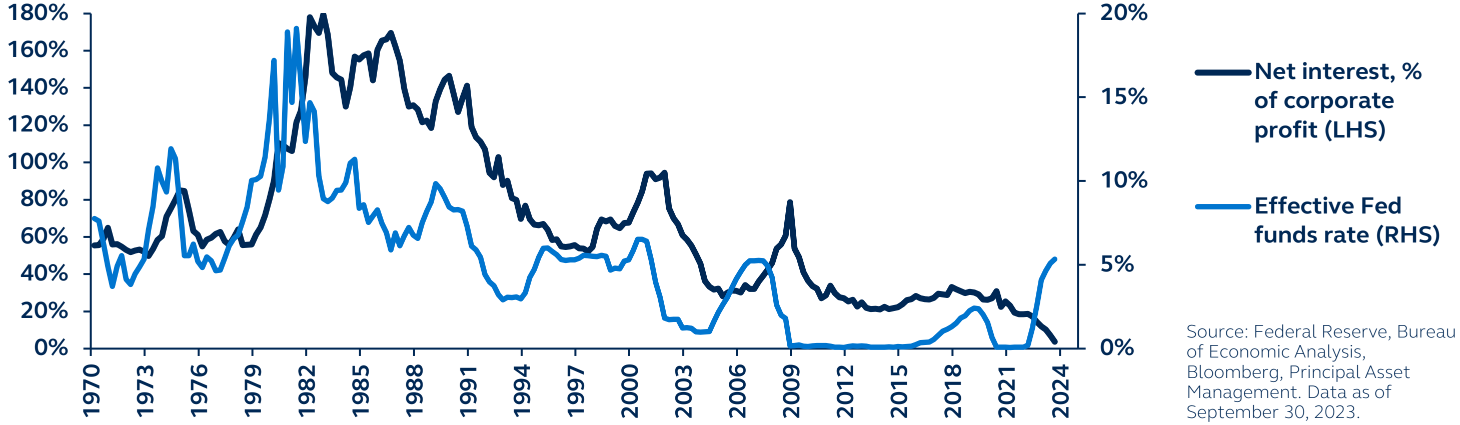
Similarly, on the corporate side, the Fed's 2020 decision to make credit cheap and easy to access for all companies encouraged corporates to take full advantage of record low rates by refinancing their debt and issuing new debt in record numbers. As a result, even as Fed rates have risen to 22-year highs, corporate interest payments trended lower.

These stimulus measures created a unique defense against higher policy rates. Rising numbers of corporate bonds are now maturing, requiring refinancing and many at significantly higher rates than their existing loans, particularly for the most leveraged issuers. The constructive economic backdrop implies that most corporates should be able to climb the maturity wall relatively unscathed, but they will have to offset their higher refinancing costs by reducing expenses elsewhere, with strategies such as cutting dividends, reducing capex, and decreasing labor costs likely to take some toll.

The U.S. economy will only start to feel the effect of higher interest rates this year. Pandemic stimulus measures did a very effective job at insulating the economy from higher rates.

Corporate interest payments versus Federal funds rate

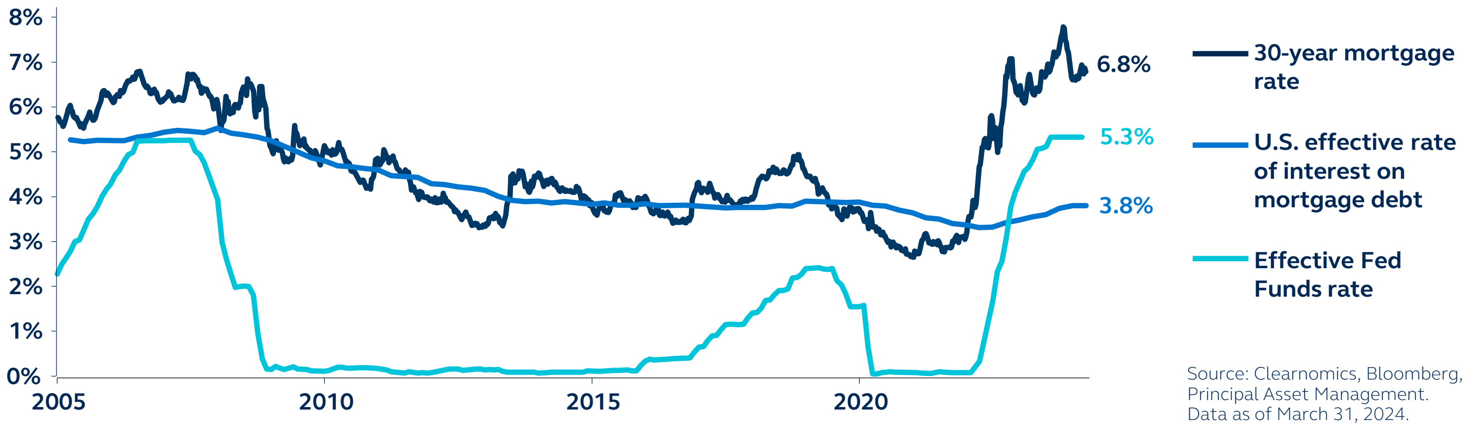
Quarterly, January 1970–September 2023



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

U.S. 30yr fixed mortgage rate, effective mortgage rate, and effective Fed funds rate

2010–present



Source: Clearnomics, Bloomberg, Principal Asset Management. Data as of March 31, 2024.

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Lower income consumers starting to feel the pinch

Household spending power has remained more robust than in previous hiking cycles. Not only have homeowners been broadly immune to rising mortgage rates, but higher rates have actually bolstered household income. Pandemic-related fiscal cash injections led to a meaningful buildup of excess savings, and higher interest rates on deposit accounts and money market funds have meant that savers received a boost to passive income. Household wealth has also risen sharply, bolstered by capital market and house price appreciation.

Yet, there are signs that some consumers are stretched:

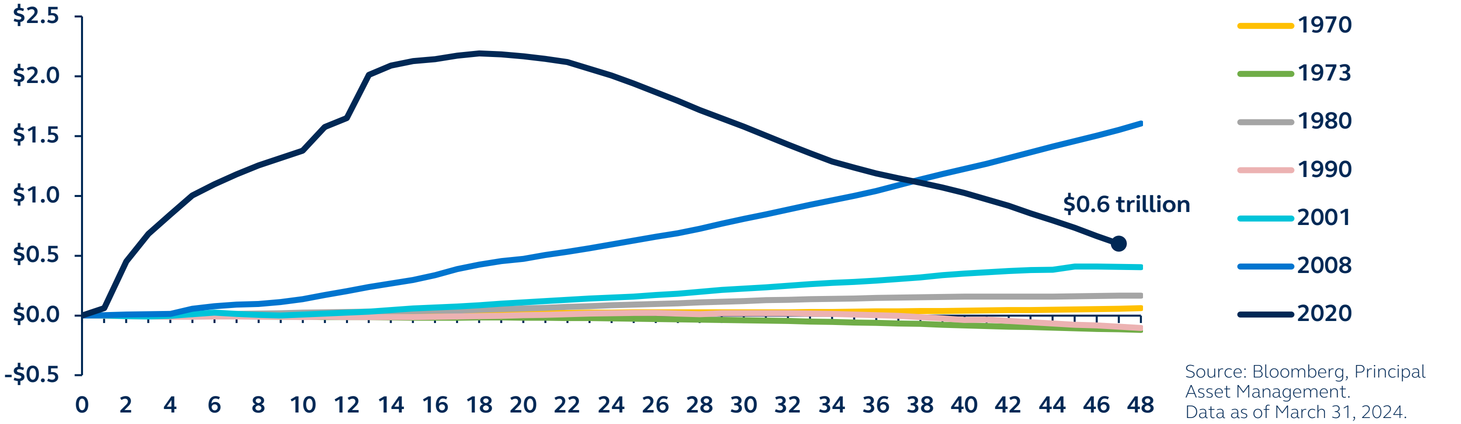
- Household balance sheets are still strong, but excess savings are becoming depleted —although this is tilted toward lower income rather than higher income households.
- A growing number of companies suggest consumers have become more value conscious, shifting away from higher priced goods toward lower priced goods.
- Credit concerns are creeping higher—the rate of credit card delinquencies has risen above pre-pandemic levels.

Dynamics that helped fuel lower income consumer strength in the past two years are now fading, leading to an increasingly fragmented economic backdrop.

While high income consumers still have excess savings and continue to benefit from positive wealth effects, lower income consumers are showing signs of strain.

Aggregate excess savings following recession

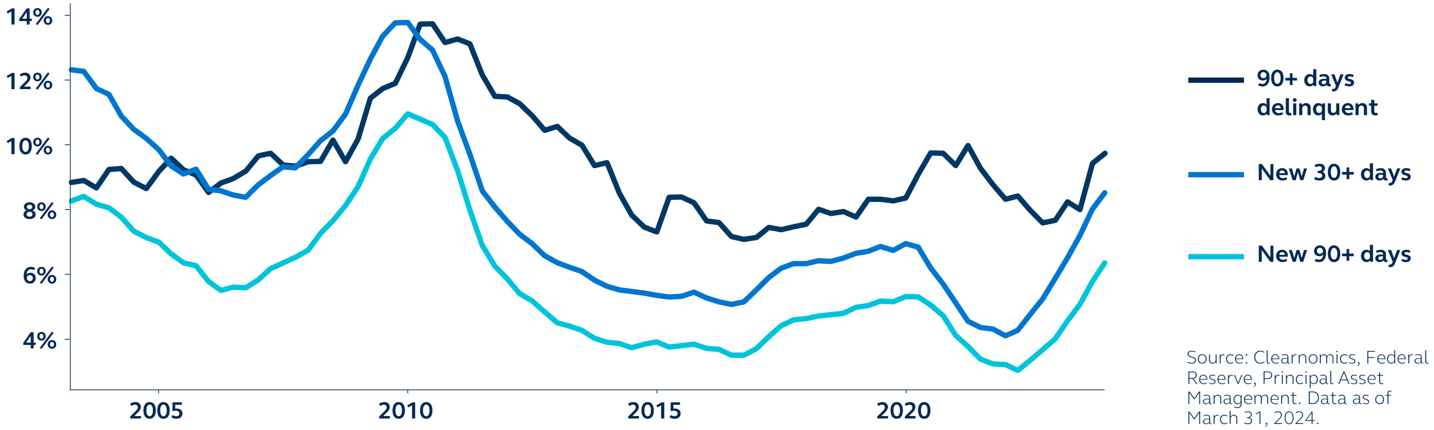
Trillions, months since start of recession



Source: Bloomberg, Principal Asset Management. Data as of March 31, 2024.

Credit card delinquency rates

Percent of current outstanding balance, quarterly, January 2003–present



Source: Clearnomics, Federal Reserve, Principal Asset Management. Data as of March 31, 2024.

Labor market: Solid but not overheating

Tightening financial conditions have not broken the economic expansion; a key reason for this has been the labor market's strength. Yet, while headline employment has continued to grow uninterrupted and has even strengthened since the turn of the year, there are growing signs of a (healthy) labor market rebalancing.

Job openings continue to drift lower, fewer people are quitting jobs to take on others, temporary employment is slowing, and fewer small businesses are planning to increase employment. Companies are beginning to respond to cooling economic activity and consumer spending by gently reducing labor demand.

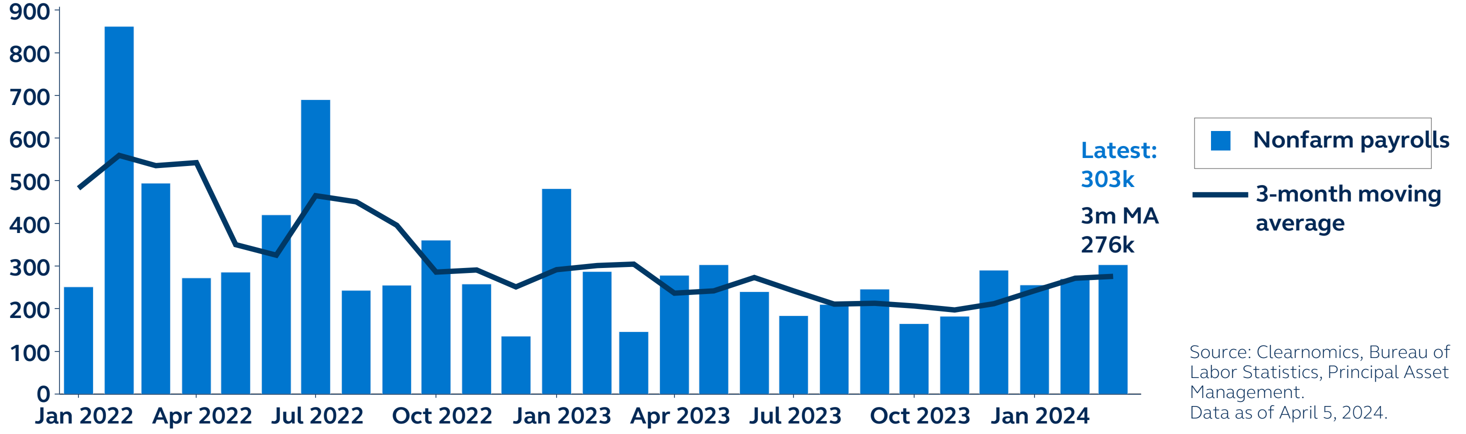
Labor supply has also risen sharply recently, largely due to a surge in immigration. This is likely the key reason behind the recent rise in unemployment, representing a “healthy” supply-driven rise in unemployment rather than an “unhealthy” demand-driven rise in unemployment. As such, while unemployment is likely to still rise incrementally, it should not be associated with recession.

More pertinently, if labor market rebalancing persists, it should support a further weakening in wage growth over the coming months, assisting the disinflation narrative.

Labor market resilience appears to be set to remain a key theme for 2024. A healthy rebalancing of labor supply and demand should ensure unemployment does not spike.

U.S. nonfarm payrolls

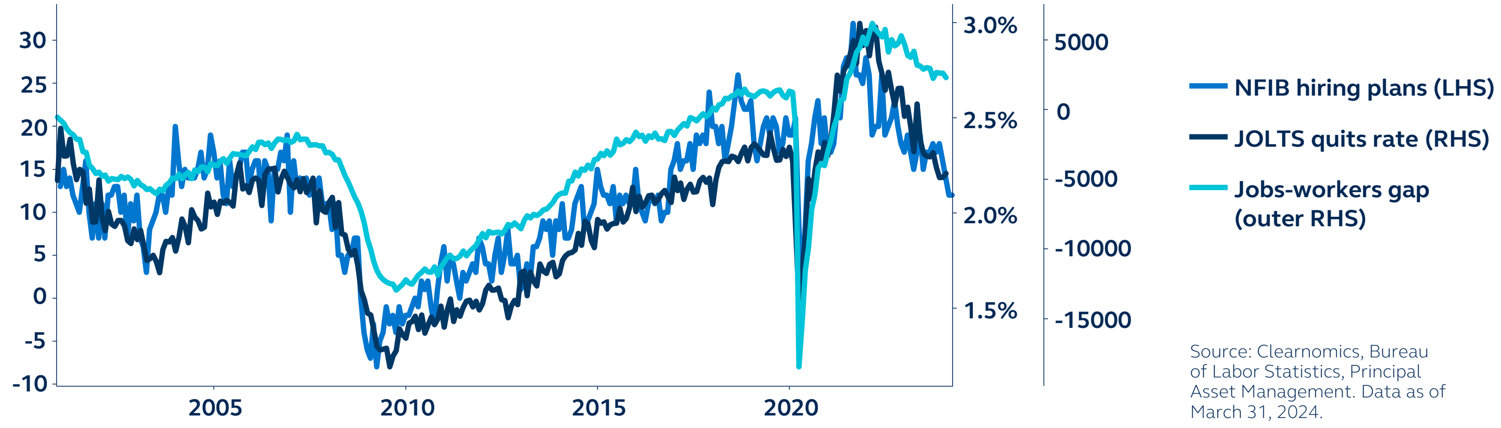
Thousands, monthly, January 2022–present



Source: Clearnomics, Bureau of Labor Statistics, Principal Asset Management.
Data as of April 5, 2024.

Labor market tightness: various measures

NFIB hiring plans, JOLTS quits rate, jobs-workers gap



Source: Clearnomics, Bureau of Labor Statistics, Principal Asset Management. Data as of March 31, 2024.

Global inflation: A frustratingly slow last mile

Global disinflation has made significant headway, and generally without job losses. However, there are now signs that inflation is no longer decelerating. Recent U.S. inflation prints represent a setback in the Fed's effort to build additional confidence in the sustainability of disinflation. While core goods inflation has dropped sharply, driven by normalizing supply chains, core services inflation ex-housing—the segment of the consumer basket most closely related to the labor market—remains strong, raising concerns that the U.S. labor market is simply too hot to permit inflation to reach the 2% target. Upcoming data will be pivotal to confirm the U.S. economy is not in the throes of a new inflationary trend.

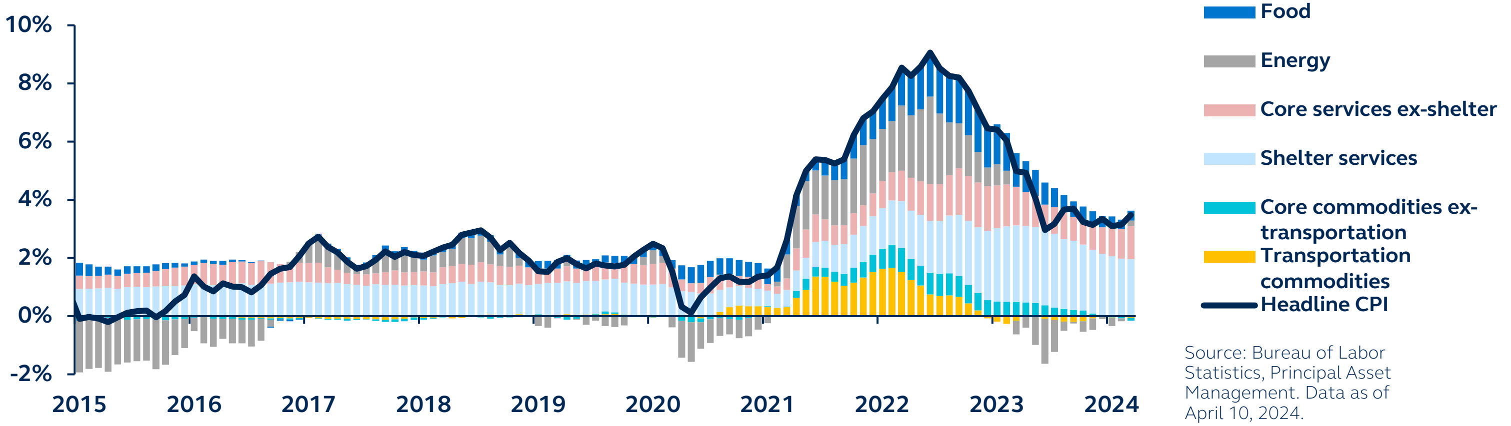
In fact, sticky services inflation appears to be a common global theme, suggesting that wider labor market cracks are required for the last mile to the inflation target.

In the UK and the Euro area, central banks are closely focused on wage growth. Lackluster economic activity suggests wage growth is likely to weaken, but clear evidence is necessary before both central banks can begin executing rate cuts. By contrast, for the Bank of Japan (BOJ), the "shunto" wage negotiations, which showed stronger-than-expected wage growth, were the final piece of the inflation puzzle to convince the BOJ to shift away from negative rates.

The last mile to central banks' inflation targets is proving tough and may require some (small) cracks in the labor markets to materialize.

Contribution to headline U.S. inflation

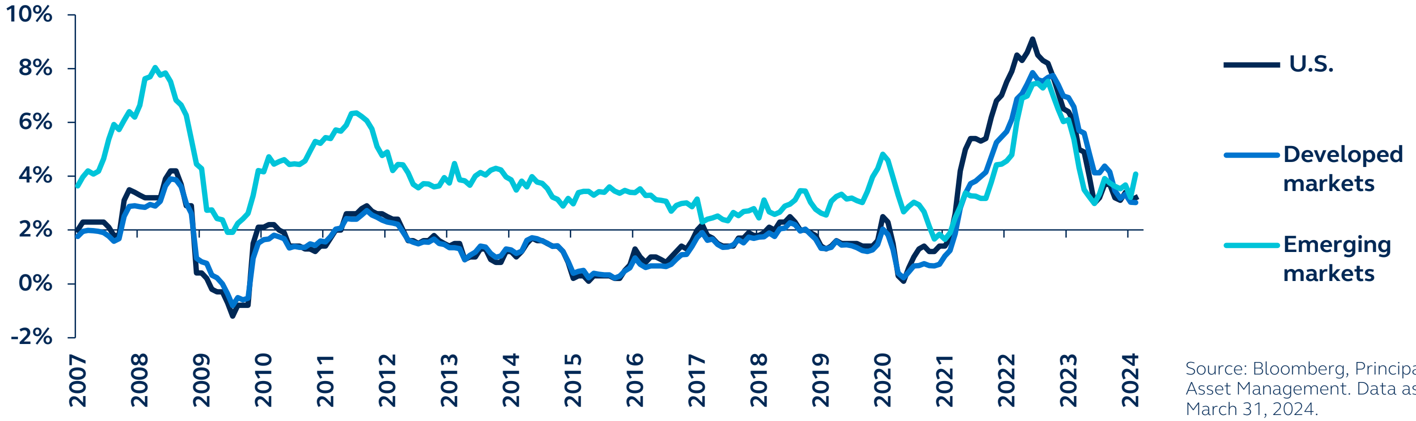
Year-over-year, January 2015–present



Source: Bureau of Labor Statistics, Principal Asset Management. Data as of April 10, 2024.

Principal Asset Allocation GDP-weighted inflation

January 2007–present



Source: Bloomberg, Principal Asset Management. Data as of March 31, 2024.

Policymakers must carefully navigate the landing

The last mile of inflation will likely be bumpy and unpredictable. Against that backdrop, small surprises in inflation can have significant consequences for the policy path and the economy.

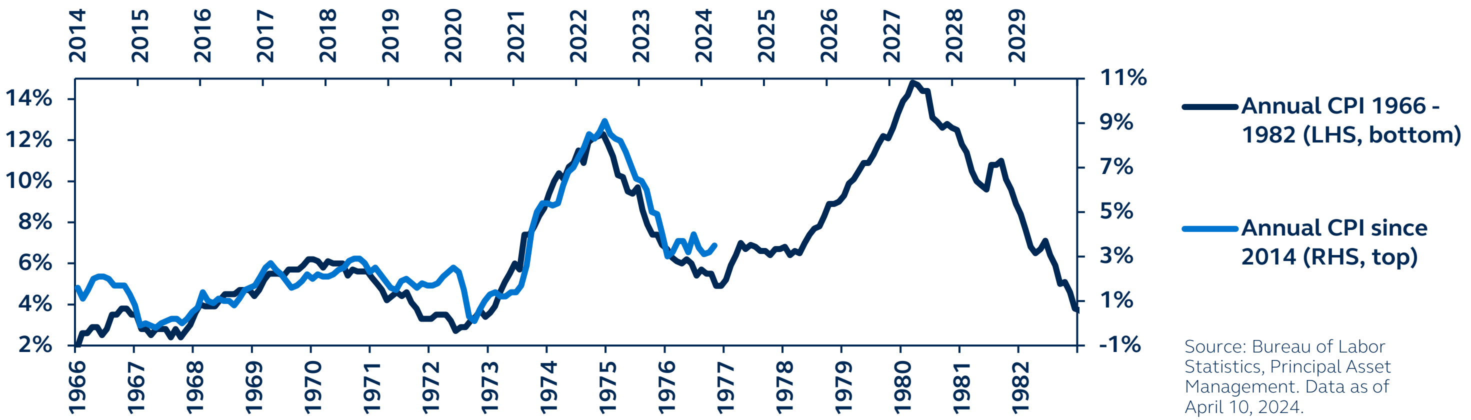
History clearly warns against cutting rates before inflation is on a sustainable path back to target. There are striking similarities between U.S. inflation developments today and those of the early 1970s. During that period, the Fed had also responded with steep interest rate hikes. After some time, it was anxious to ease monetary policy, cutting interest rates before inflation had fallen back to levels consistent with price stability. The result was a resurgence in price pressures.

However, the very limited number of successful soft landings also demonstrates the dangers of waiting too long before cutting rates. If the Fed were to keep policy rates on hold at 5.5%, falling inflation would imply a rising real policy rate and, therefore, a tightening monetary stance. As such, keeping rates on hold for too long risks throwing away the strong prospects of achieving a soft landing—the Fed must navigate its policy path very carefully.

The Fed must tread carefully to ensure it does not trigger a new inflation wave. However, leaving policy rates unchanged for too prolonged a period would raise recession risk.

Historical inflation comparison

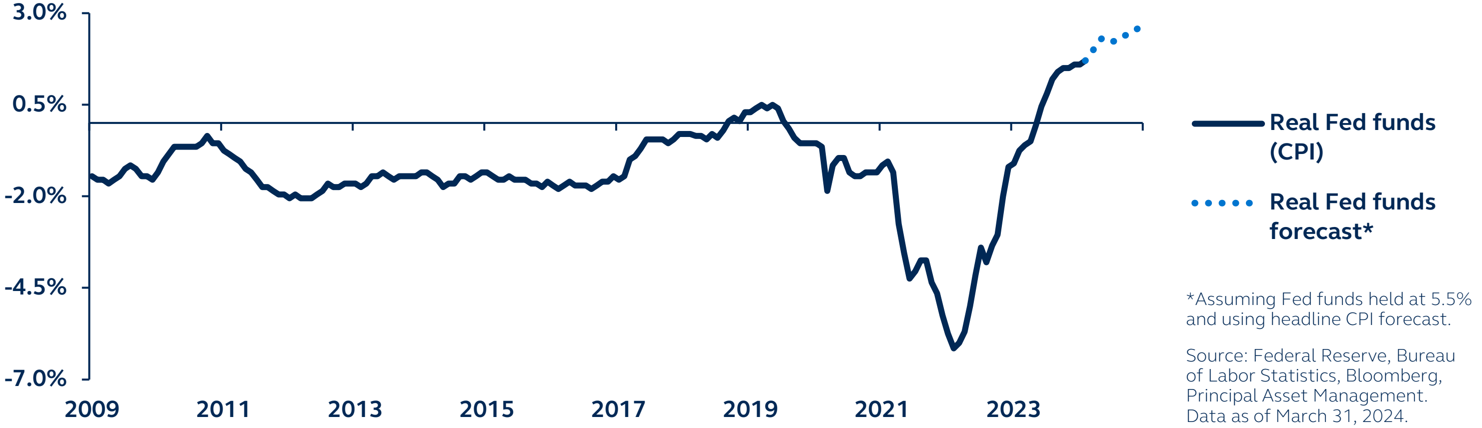
Consumer Price Index (CPI)



Source: Bureau of Labor Statistics, Principal Asset Management. Data as of April 10, 2024.

Real Fed funds rate

January 2009–present



*Assuming Fed funds held at 5.5% and using headline CPI forecast.

Source: Federal Reserve, Bureau of Labor Statistics, Bloomberg, Principal Asset Management. Data as of March 31, 2024.

Federal Reserve: Eager to cut rates

The past few months have been a particularly volatile period for Federal Reserve forecasts. Upside inflation surprises mean that financial market expectations have shifted from six Fed cuts this year to just two cuts, starting in September.

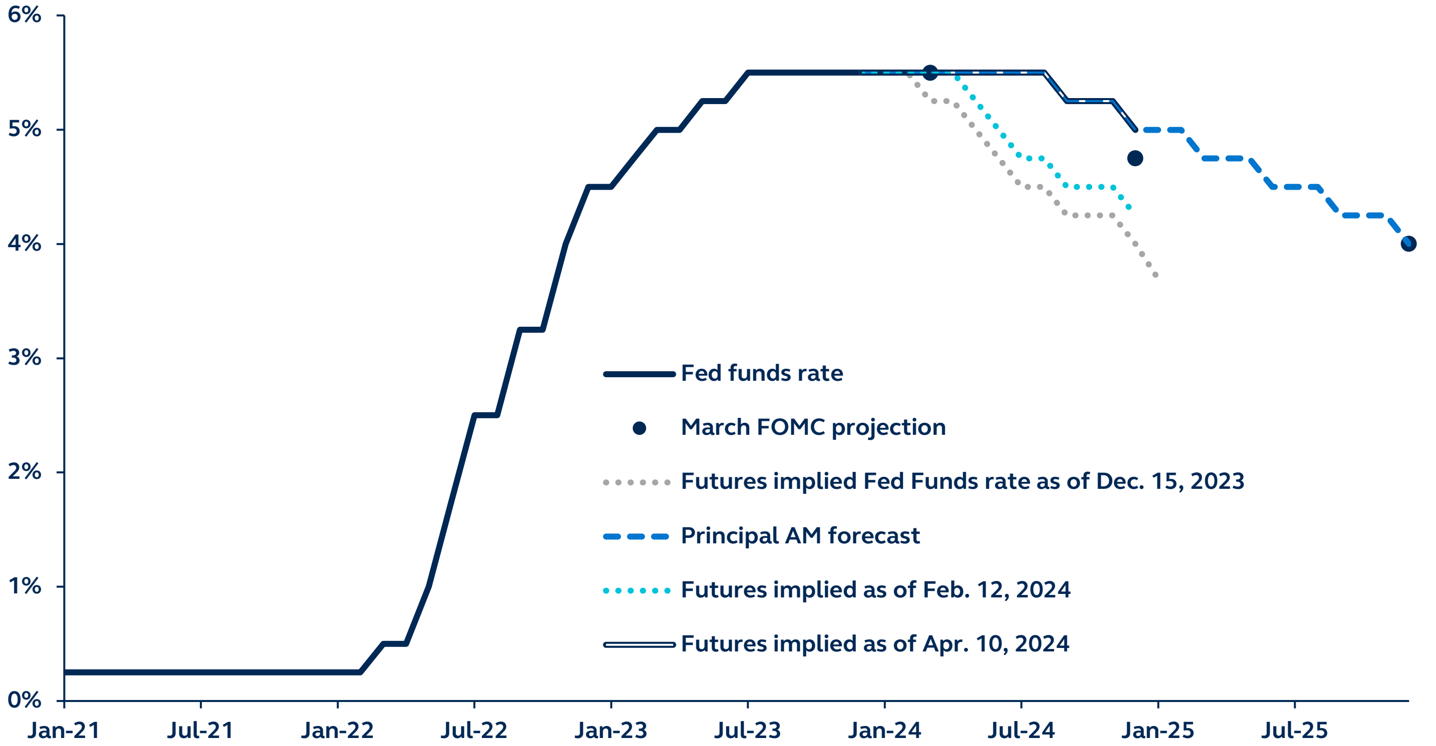
The Fed, and in particular Chair Powell, have made it abundantly clear that it wants to cut rates this year. Not only has it been downplaying the importance of recent inflation prints, but upward revisions to the Fed's growth and inflation forecasts did not prompt any changes to the near-term policy path projection. The Fed continues to expect 75 basis points of cuts this year.

The strength of the economy means that only one cut is likely required, yet we must take consideration of the Fed's clear desire to cut rates into account. We have revised our forecast from three cuts to two cuts in 2024, with the first reduction coming in September. The complications of starting an easing cycle just before the U.S. Presidential election does insert significant uncertainty. Investors should note that cutting policy rates when the economy is running above trend and while unemployment is still near record lows raises the risk of another inflation wave. The implication is that the Fed's loosening cycle will be historically shallow, with rates ultimately higher for longer.

The Fed clearly wants to cut rates. We are expecting two rate cuts in 2024, starting in September. However, loosening policy at a time when growth is still strong is a risky strategy.

Federal Reserve policy rates path

Fed funds rate and projections, 2021–present



Source: Federal Reserve, Bloomberg, Principal Asset Management. Data as of April 10, 2024.

Global central banks: More reason to cut than the Fed

Typically, as the largest economy in the world, the U.S. sets the stage, and global central banks wait for a signal from the Fed before they begin their easing cycles. Moving before the Fed risks putting upward pressure on their local currencies and, in turn, weighing on their economies.

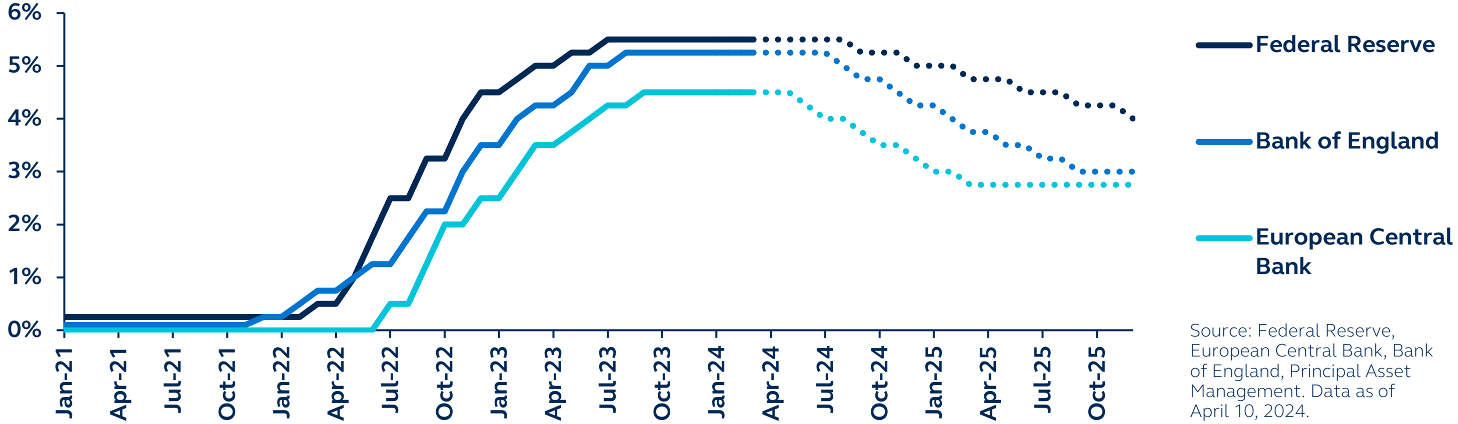
Yet the European Central Bank (ECB) and the Bank of England (BoE) are struggling with weak economies and have a clearer need to loosen monetary policy than the Fed. They too are waiting to gather sufficient evidence of sustained disinflation before they enact a rate cut. We expect the ECB rate cutting cycle to be delayed until June and, for the BoE, potentially late summer. However, both central banks will likely be uncomfortable starting their cutting cycles several months ahead of the Fed.

Once they do start cutting rates, the BoE and ECB are likely to move with more urgency than the Fed as they are facing a greater risk of protracted economic downturns. As a result, the U.S. dollar will likely see an extended period of strength, only slightly muted by the Bank of Japan's policy moves towards a more restrictive setting.

Global central banks typically would prefer to start cutting rates at the same time as the Fed. Yet their weaker economies mean they will likely move with greater urgency. Their relatively dovish policy path will keep upward pressure on the U.S. dollar.

Global central bank rates

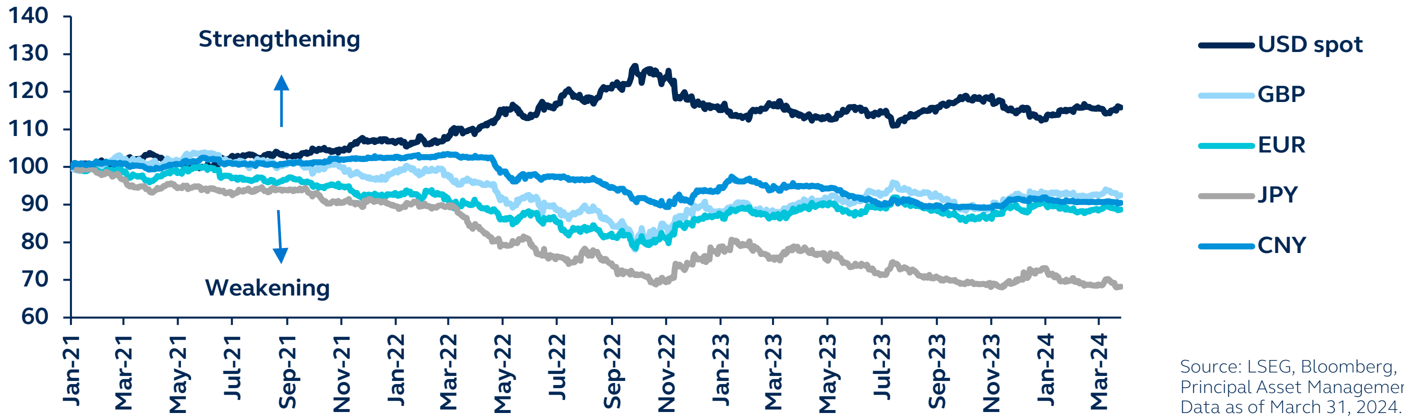
January 2021–present, forecasted through 2025



Source: Federal Reserve, European Central Bank, Bank of England, Principal Asset Management. Data as of April 10, 2024.

Major currencies

Rebased to 100 at January 2021



Source: LSEG, Bloomberg, Principal Asset Management. Data as of March 31, 2024.

Fixed income

U.S. Treasurys are likely set to skew lower, but only slightly

1Q was a challenging quarter for U.S. Treasurys as constructive economic data prompted markets to revise their Fed rate expectations path to a significantly less dovish one. U.S. Treasury yields corrected higher, albeit not quite to the highs of early 4Q 2023. With the Fed likely to start cutting rates around mid-year, Treasury yields should skew lower as investors look to lock in the current level of yields.

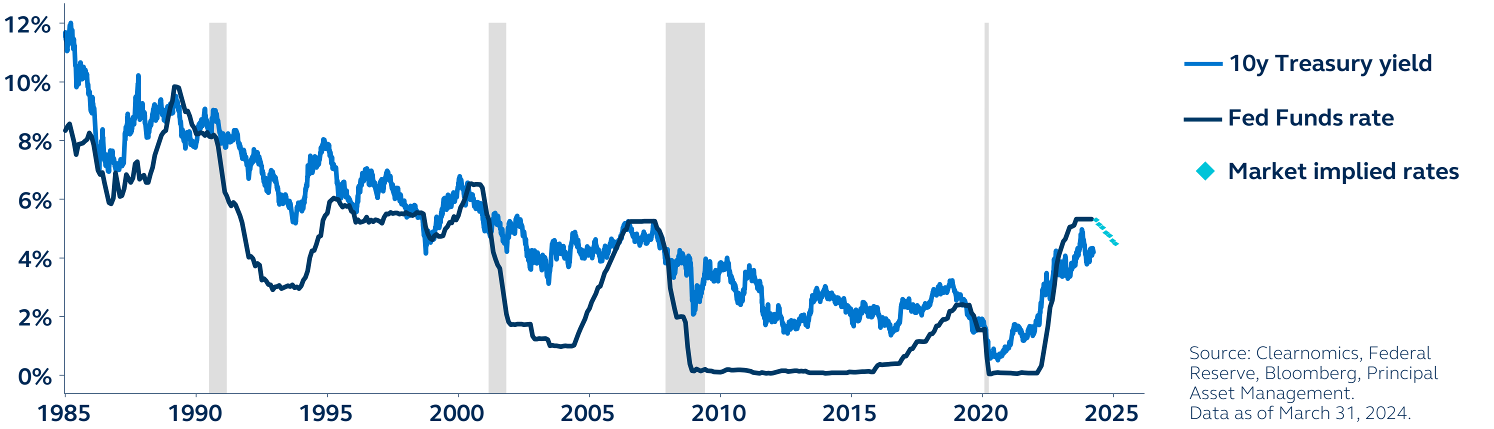
However, in the absence of a severe recession, Treasury yields are unlikely to revert to the ultra-low levels of recent years. With inflation set to remain above the 2% target for much of the forecast horizon, the Fed's easing cycle will be considerably more shallow than usual. In addition, shifting supply/demand dynamics in the Treasury space, particularly in an election year, imply higher term premia.

By contrast, credit had a strong quarter, supported by the still strong economic backdrop. Credit spreads are at historically tight levels and, in a soft landing scenario, should remain fairly tight. Note, though, that the prospect of a modest economic slowdown suggests limited room for further spread compression.

Fed rate cuts should put downward pressure on U.S. Treasurys but the impact will likely be limited by a shallow cutting cycle, as well as higher term premia as debt concerns persist.

Fed funds rate and U.S. 10y Treasury bond yield

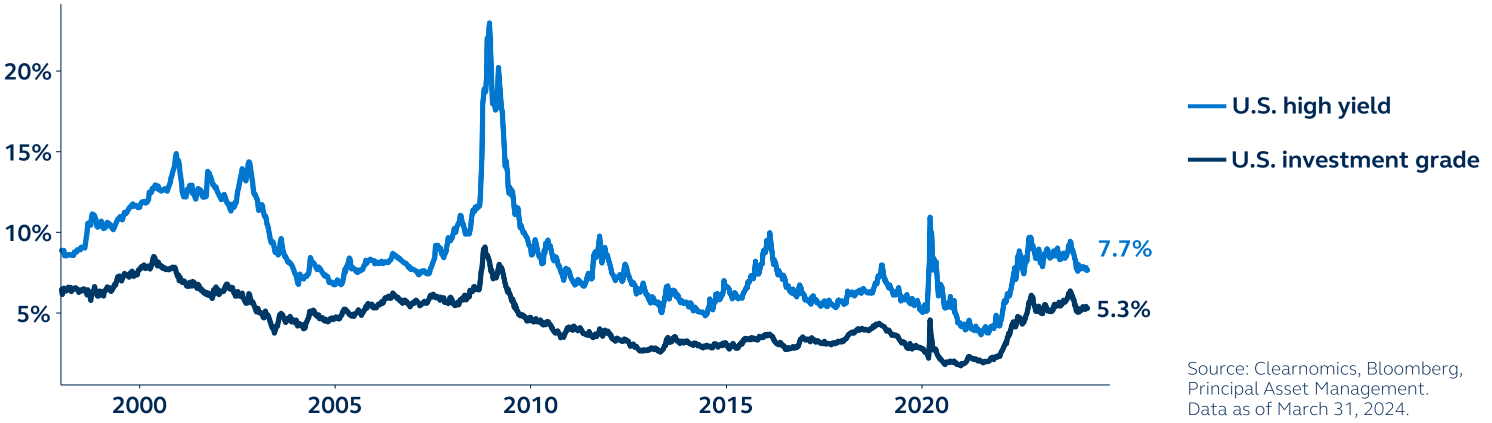
Recessions are shaded, 1985–present



Source: Clearnomics, Federal Reserve, Bloomberg, Principal Asset Management. Data as of March 31, 2024.

U.S. high yield and investment grade spreads

Option-adjusted-spread, 1998–present



Source: Clearnomics, Bloomberg, Principal Asset Management. Data as of March 31, 2024.

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Fixed income: We're here for the carry

The combination of solid economic growth and a Fed that is clearly keen to cut policy rates has solidified a constructive backdrop for credit. Higher yields and lower interest rate volatility should continue to support strong institutional demand while ETF inflows reflect healthy retail appetite.

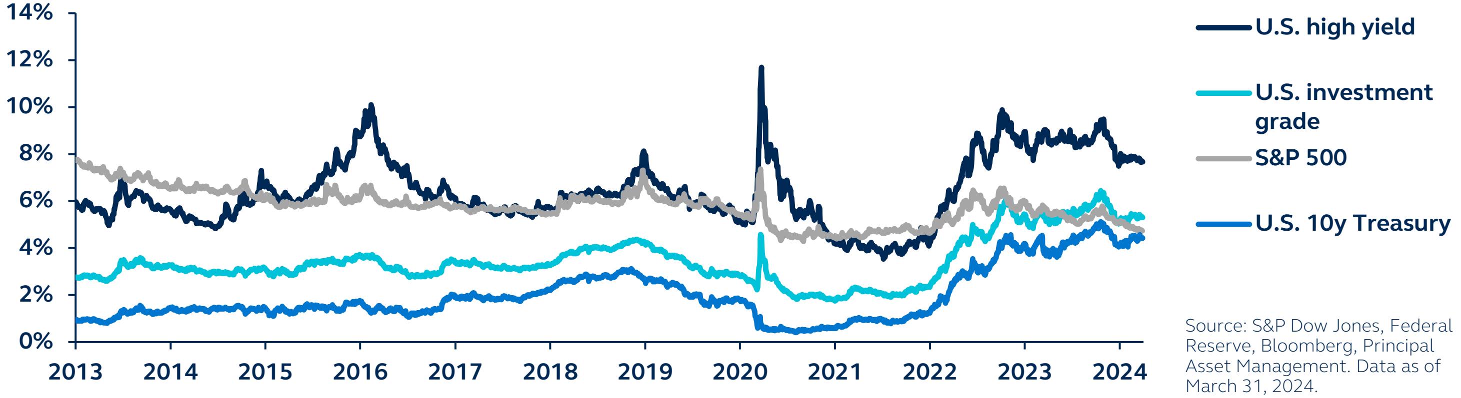
Spreads are historically tight for both investment grade and high yield credit. Yet while spreads may not tighten significantly from here, provided the economy does not deteriorate significantly, they should not widen much either. More pertinently, credit is offering important additional carry to U.S. Treasurys, while the total yield available in fixed income is also attractive compared to equities.

A much-flagged risk for high yield this year is that, due to the Fed's 2022-23 hiking cycle, the wall of maturing debt will face significantly higher refinancing costs, potentially triggering a spike in defaults. However, the resilient macro backdrop and strong balance sheets suggest that companies should scale the wall relatively unscathed. In addition, the maturity wall leans towards high-quality, suggesting that most companies will be able to digest the interest rate costs without too much strain.

Although credit spreads remain tight, the fixed income asset class is offering important carry opportunities. Concerns around the high yield maturity wall are likely overblown.

Yield comparison: High yield bonds, investment grade bonds, U.S. Treasurys, and S&P 500

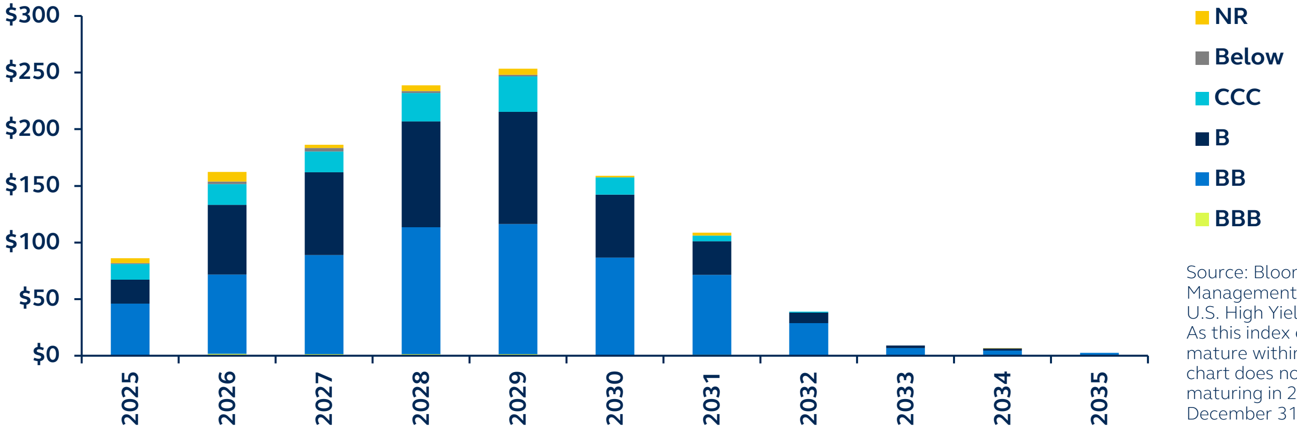
High yield bond yield-to-worst, investment grade bond yield-to-worst, U.S. Treasury yield-to-worst, S&P 500 12m forward earnings yield



Source: S&P Dow Jones, Federal Reserve, Bloomberg, Principal Asset Management. Data as of March 31, 2024.

High yield bond maturity schedule

Billions USD



Source: Bloomberg, Principal Asset Management. Data represents the U.S. High Yield 2% Issuer Cap index. As this index excludes bonds that mature within the next year, the chart does not include any bonds maturing in 2024. Data as of December 31, 2023.

Principal Asset Management℠

The wall of cash is looking for a new home

Assets in money market funds have ballooned to a record $6 trillion, with investors attracted by elevated yields and partially hiding from an uncertain U.S. economic outlook. Now, with rate cuts on the near-term horizon, this cash may represent a potential tailwind to risk assets.

Many of the concerns and questions of recent years should finally be resolved over the coming months. The economy is slowing but appears to be on course for a soft landing, earnings growth will likely remain positive, and the Fed is likely to cut rates this year, reducing the attractiveness of cash.

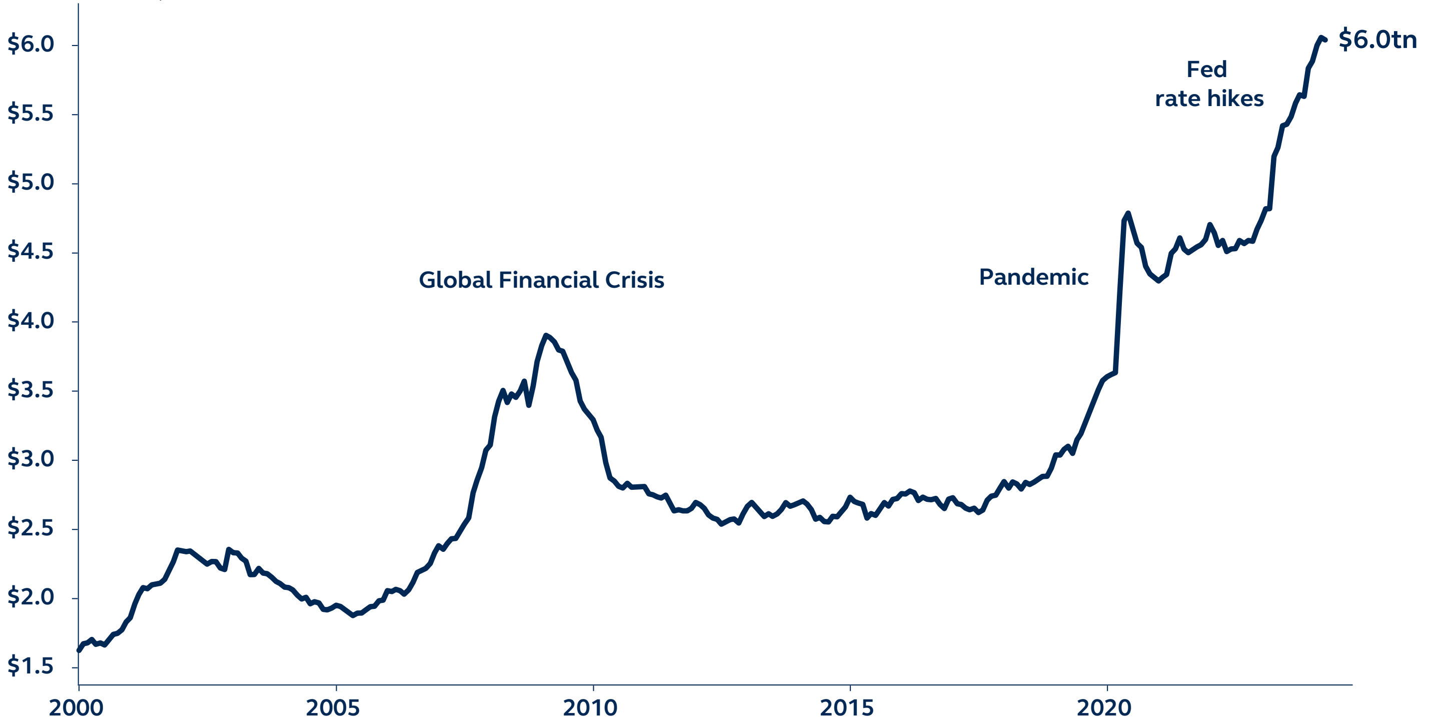
Non-cash assets can deliver solid returns and provide important diversification in portfolios. In the base case scenario, a soft landing, risk assets like equities should outperform. If, however, this is too optimistic and recession materializes, bonds can offer stability and a hedge against the downside risks. If inflation resurges, alternatives such as real assets can outperform. With the potential for gains across the asset class spectrum, the main risk is staying in cash.

Investors should be prepared: Rate cuts should ignite a surge in sentiment—and there's a massive $6 trillion mountain of cash to fuel the resulting rally in risk assets.

Money market funds have surged in recent years but, in 2024, with rate cuts likely and the economy still on a positive path, risk assets should perform strongly, and cash is likely set to lose its attractiveness.

U.S. total money market fund assets

Trillions, 2000–present



Source: Clearnomics, Federal Reserve, Investment Company Institute, Bloomberg, Principal Asset Allocation. Data as of March 31, 2024.

INDEX DESCRIPTIONS

Bloomberg U.S. High-Yield Corporate Bond Index is a rules-based, market-value-weighted index engineered to measure publicly issued non-investment grade USD fixed-rate, taxable and corporate bonds.

Bloomberg U.S. Corp High Yield 2% Issuer Capped Index is an unmanaged index comprised of fixed rate, non-investment grade debt securities that are dollar denominated. The index limits the maximum exposure to any one issuer to 2%.

Bloomberg 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 U.S. and non-U.S. corporations.

Bloomberg U.S. Treasury Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury. Treasury bills are excluded by the maturity constraint. STRIPS are excluded from the index because their inclusion would result in double-counting.

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, Australasia, 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 Europe Banks Index is composed of large and mid cap stocks across 15 Developed Markets countries in Europe. All securities in the index are classified in the Banks industry group (within the Financials sector) according to the Global Industry Classification Standard (GICS®).

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 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 U.S. 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 U.S. market.

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

MSCI 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 U.S. equity market.

MSCI USA Value Index captures large and mid cap U.S. 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.

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.

U.S. dollar index (USDX) is a measure of the value of the U.S. dollar relative to a basket of foreign currencies.

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.

IMPORTANT INFORMATION

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. Non-investment grade securities offer a potentially higher yield but carry a greater degree of risk. Risks of preferred securities differ from risks inherent in other investments. In particular, in a bankruptcy preferred securities are senior to common stock but subordinate to other corporate debt. Emerging market debt may be subject to heightened default and liquidity risk. Risk is magnified in emerging markets, which may lack established legal, political, business, or social structures to support securities markets. Small and mid-cap stocks may have additional risks including greater price volatility. Treasury inflation-protected securities (TIPS) are a type of Treasury security issued by the U.S. government. TIPS are indexed to inflation in order to help investors from a decline in the purchasing power of their money. As inflation rises, rather than their yield increasing, TIPS instead adjust in price (principal amount) in order to maintain their real value. Inflation and other economic cycles and conditions are difficult to predict and there Is no guarantee that any inflation mitigation/protection strategy will be successful. Contingent Capitals Securities may have substantially greater risk than other securities in times of financial stress. An issuer or regulator's decision to write down, write off or convert a CoCo may result in complete loss on an investment. Real assets include but not limited to precious metals, commodities, real estate, land, equipment, infrastructure, and natural resources. Each real asset is subject to its own unique investment risk and should be independently evaluated before investing. As an asset class, real assets are less developed, more illiquid, and less transparent compared to traditional asset classes.

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