Principal Global Insights

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# Global Asset Allocation Viewpoints

## 3Q 2021: Navigating global markets in transition

The economic recovery continued to accelerate during the second quarter. Decisive monetary and fiscal policies, strong growth, and increasing vaccinations have helped drive an unusually sharp recovery in risk assets from their COVID-19 lows last year. However, inflation concerns and uncertainty around central bank policy going forward has disrupted the risk-on sentiment that dominated markets the first half of the year.



Bond yields fell back as the United States economy showed signs of reaching peak recovery, and investors raised questions around U.S. Federal Reserve (Fed) tolerance for inflation-overshooting, leading global equity markets to stumble. U.S. equities put in a solid performance in Q2, while European equities played catch-up, returning to pre-pandemic levels. Emerging markets steadied their performance toward the latter part of the quarter.

### As vaccinations progress, COVID-19 continues to hang heavy over some markets.

- U.S. vaccination numbers continue to climb, but at a slowing pace as the country approaches critical coverage. Europe's vaccination campaign is now far outpacing the U.S., reflected in the strong performance of European assets.
- There continues to be a large gap between vaccination rates in the developed markets (DM) and the emerging markets (EM), with EM lagging sharply behind. While vaccinations have sped up recently in some EM countries, it will probably be later this year or early next before these regions reach vaccination levels currently seen in the U.S. or Western Europe.

### Inflation pressure should be short-lived, but labor markets in the U.S. and Europe remain strained.

- Markets have been extremely animated about inflation, fueled by higher-than-expected CPI numbers during the second quarter. However, most of the factors driving this price surge are typically short-lived, suggesting that inflation should eventually fall back.
- While labor demand is strong in the U.S., supply is constrained in the short-term and weighing on the recovery. Job openings have surged to roughly equal to the number of unemployed individuals, suggesting a mismatch between companies' needs and workers' skills.
- Unemployment in Europe rose in the second quarter as government furlough schemes ended. This will likely continue through 2021 as fiscal support ends and businesses are forced to make job cuts. Nonetheless, with a strong consumer spending bounce likely from economic reopenings, the labor market fallout shouldn't weigh significantly on European economic activity.

### Easy financial conditions and strong earnings continue to support risk assets globally.

- The global cyclical upturn in equity markets is spreading in a staggered fashion as vaccine progress broadens, which is reflected in de-synchronized regional performance.
- High valuations may slow returns, but strong fundamentals should continue driving cyclicals and secular growth performance.
- Supply bottlenecks are keeping growth in DM from translating to EM growth in the short term, although the long-term outlook is positive in EM, given structural advantages.

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# **Macro insights:** Global economies

## COVID-19 still plays a key role in global performance.

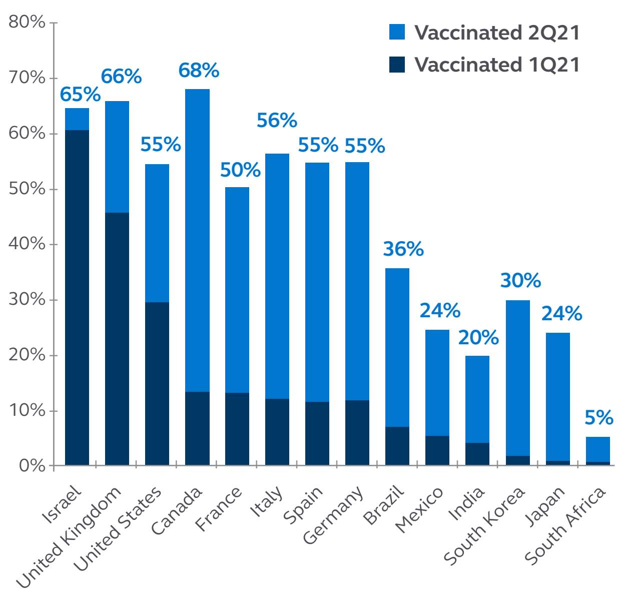
***Vaccination progress is broadening, but emerging markets lag.***

The pandemic continues to hang over global markets as vaccination dynamics are heavily influencing near-term outcomes. The start of the year saw optimism about U.S. assets where the pace of the vaccine rollout was rapid, while there was more pessimism about Europe and the rest of the world as they appeared to be lagging in the vaccine procurement and distribution race.

U.S. vaccination numbers continue to climb, but at a slowing pace as the country approaches critical coverage. Europe's vaccination campaign is now far outpacing the U.S., which is reflected in recent strong performance of European assets. Meanwhile, the large gap between DM and EM vaccination rates means that it will probably be later this year or early 2022 before these regions reach vaccination levels currently seen in the U.S. or Western Europe.

### Vaccination rates in selected countries

*% of population that has received at least one vaccine dose*




Source: Our World in Data, Principal Global Asset Allocation. Data as of June 30, 2021.

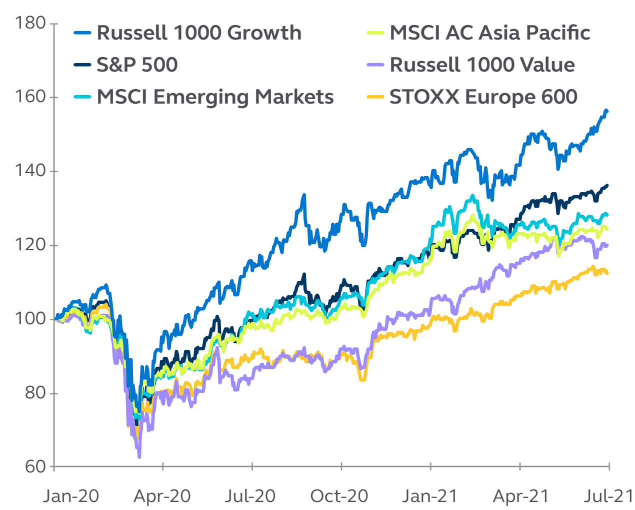
## The global cyclical upturn is spreading, but staggered.

***While U.S. equities have lost steam, European stocks are catching up.***

Inflation uncertainty and unease around central bank policy have now partially disrupted the risk-on sentiment that has pervaded markets for the best part of the last 12 months. Bond yields switched direction early in the second quarter, falling back as the U.S. economy showed signs of reaching peak recovery, raising questions around the Fed's tolerance for inflation-overshooting and leading some global equity markets to stumble.

### Global market performance

*Index returns, local currencies, rebased to 100, January 1, 2020 – June 30, 2021*




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

***Developed markets have been leading the global rebound . . .***

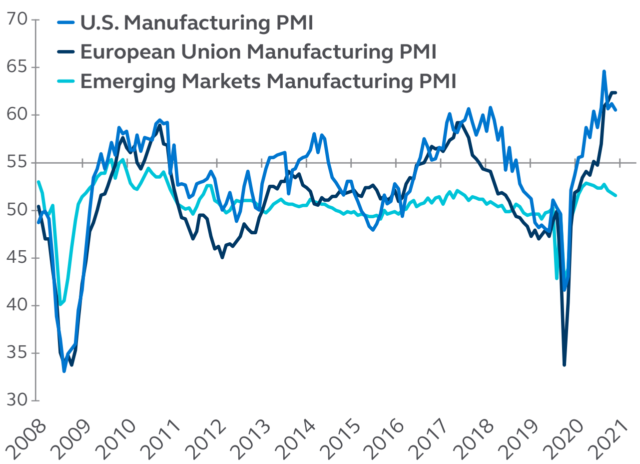
Growth in the U.S. had already accelerated sharply in the first quarter as states started reopening, creating a tough jumping-off point for second quarter growth. While manufacturing and services activity surveys continue to show very strong headline figures, they've stopped beating expectations. This suggests the U.S. economy likely hit peak recovery in 2Q21.

Europe continues to record sharp near-term growth improvements. The rise in mobility as countries have reopened has levered the economy to a sharp acceleration in activity, pushing manufacturing PMIs to all-time highs, with service PMIs not far behind. The room for further acceleration from here looks more limited, however, and Europe may hit peak recovery as soon as 3Q21.

By contrast, EM economic activity slowed outright during the second quarter, pulled down mainly by India as momentum has been slowing in South Asian manufacturing. This is due to the region's producers struggling to meet demand in the technology and automobile sectors resulting from significant bottlenecks in supply chains. These supply constraints are also obstructing the transmission of DM economic strength to EM.

### PGAA Purchasing Managers Indices

*Index level, May 2008 – June 2021*




Source: Bloomberg, FactSet, Principal Global Asset Allocation. PGAA Purchasing Manager Index models start in May 2008. Data as of June 30, 2021.

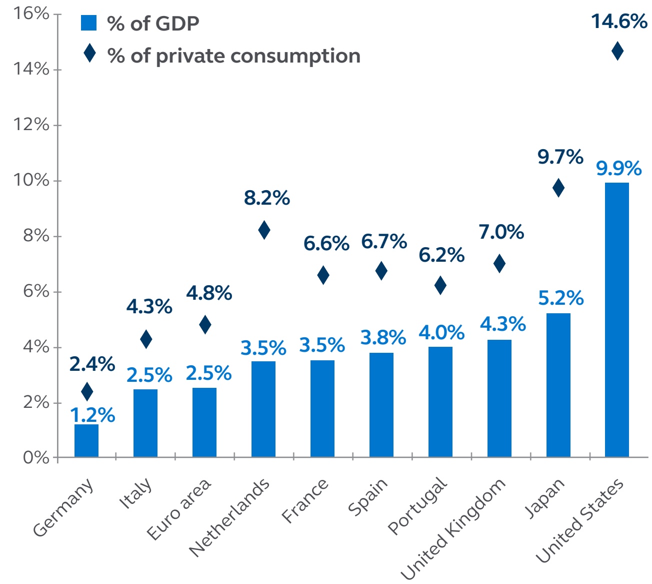
***… lining up the ingredients for a spending boom.***

One of the more remarkable aspects of the pandemic recession and recovery has been the resilience of household purchasing power. The pandemic environment has created a tremendous war chest of excess savings, and consumers in the U.S., Europe, and China have record levels of savings.

In the U.S., households accumulated nearly $2.5 trillion in excess or "forced" savings during the pandemic due to lack of spending, and as a result of the significant fiscal support provided. Similarly, in Europe, COVID-19 restrictions limited spending. Savings as a share of household disposable income soared, and provided significant cash to fund pent-up demand. Once policy support ends, consumer spending will sustain the recovery.

### Household excess bank deposits in 2020

*Percent, calendar year 2020*




Source: OECD, Principal Global Asset Allocation. Data as of June 30, 2021.

## The U.S. jobs recovery is struggling against labor supply constraints.

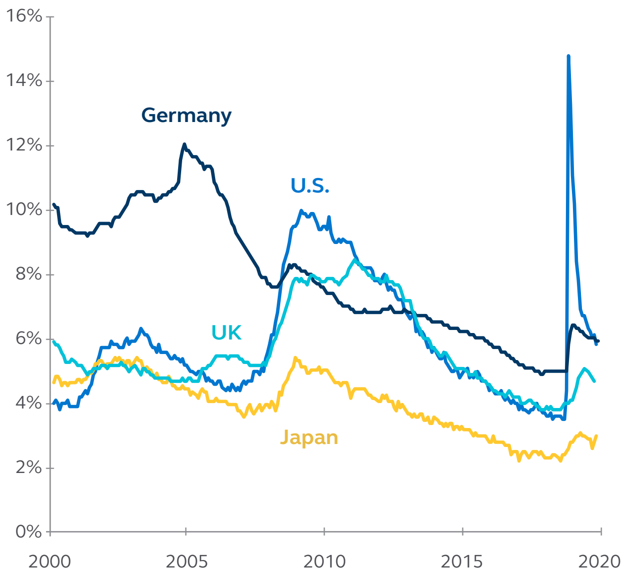
***While European labor markets are finally feeling a bit of the pandemic heat.***

Unemployment rates in Europe rose in the second quarter, a result of government furlough schemes ending. This dynamic will likely continue through 2021 as fiscal support schemes are phased out and European businesses are forced to make job cuts. Regardless, with economic reopenings and a strong consumer spending bounce likely, employers' demand for labor is likely to increase in the months ahead.

The U.S. labor market is feeling the most tightness. Non-farm payrolls remain 6.8 million below the pre-COVID peak, and more than 40% of unemployed persons have been out of work for 27 weeks or longer. Although labor demand is certainly strong, labor supply is constrained in the short-term. It seems there's a skills mismatch between what companies are looking for and what those searching for work possess, and this weighs on recovery.

### Civilian unemployment rates

*Seasonally adjusted, percent, 2000 – present*



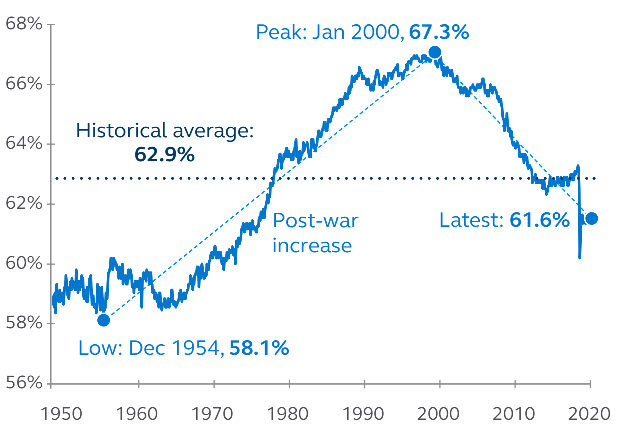

Source: Bureau of Labor Statistics, Bloomberg, Principal Global Asset Allocation. Data as of June 30, 2021.

***Fiscal support has muted the incentive to return to work.***

At the same time, generous unemployment benefits are likely holding back employment gains. With some people earning more—or at least as much—from collecting these benefits, the incentive to return to work has been muted. But with unemployment benefits set to expire over the summer, participation should start to edge higher and a healthier labor market may be on the horizon. Continued vaccination progress should also reduce COVID-19 hesitancies and support workplace confidence.

### Labor force participation

*Percent of population working or actively seeking work divided by the working age population*




Source: Bureau of Labor Statistics, Clearnomics, Principal Global Investors. Data as of June 30, 2021.

## Supply pressures and base effects are creating an inflation surge.

***But markets increasingly see inflation less pronounced long-term.***

Markets have been extremely animated about inflation recently, fueled by higher-than-expected CPI numbers during 2Q. Annual CPI inflation has risen to its highest since mid-2008, while core PCE readings have reached a 29-year high. However, most of the factors driving this price surge are typically short-lived, suggesting that inflation should eventually fall back.

Base effects (i.e., the impact of comparing a data point today to one from a period outside of the normal distribution) are driving the 12-month year-on-year inflation rate artificially higher because they're compared to low mid-pandemic price levels. Even if prices weren't to increase at all for the next few months, base effects would imply elevated inflation prints for the remainder of this year and into mid-2022.

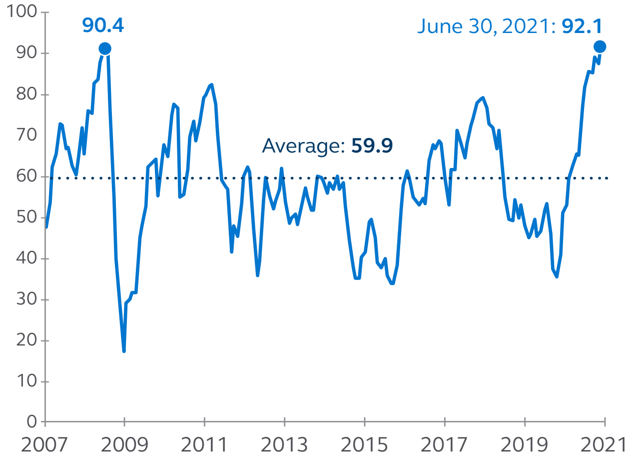
The reopening of the economy is triggering a surge in the prices of goods and services typically associated with the release of pent-up demand (e.g., eating out, travel, sporting events). Once the euphoria of a return to "normality" fades, these inflationary pressures should also fade.

Additionally, components that would be most impacted by supply constraints (i.e., cars, technology, home furnishings) also show elevated inflation relative to history. This dynamic has been mirrored in many surveys, including the ISM Prices Paid Index. Supply bottlenecks have extended delivery times as suppliers struggle to meet elevated demand, and with companies scrambling to get a hold of goods to fulfill their orders, input costs have risen. Ultimately, we believe that the supply impact should be transitory as firms adjust their supply chain. There's always the risk that transitory becomes more permanent. Investors should keep an eye on factors that may cause inflation to be stickier: rising inflation expectations, labor market tightness, and companies passing higher costs to consumers.

So far, despite elevated price pressures, long-term inflation expectations remain well-anchored around the 2% level.

### Bloomberg ISM Prices Paid

*Index, 2007 – present*




Source: Bloomberg, Institute for Supply Management, Principal Global Asset Allocation. Data as of June 30, 2021.

The biggest question in the inflation debate remains: Will U.S. output and employment overheat in the next few years? While GDP is back to its pre-pandemic level, we still see significant slack in the U.S. economy based on the remaining jobs shortfall of 6.8 million. In addition, the fiscal impulse is turning negative this year and eventually excess savings will be whittled down, suggesting fundamental inflation pressures should fade in time.

The U.S. is by no means alone when it comes to inflation surges. Globally, inflation is rising. The United Kingdom is showing a significant move up in core inflation, while in the Euro area there have been some clear upward dynamics in the durable goods category, pointing to supply constraint-led price pressures. Emerging markets have been struggling with elevated inflation readings for some time, with food prices and commodity prices fueling recent surges.

## The Fed has been extolling the virtues of inflation patience.

***But actions speak louder than words and markets are doubting the central bank's tolerance for inflation.***

Markets have become increasingly preoccupied and confused by the Fed's potential response to the rise in inflation. While the Fed has clearly indicated that it views the recent rise in inflation as transitory, its "dot plot" raises questions about the central bank's comfort level with its new inflation targeting framework.

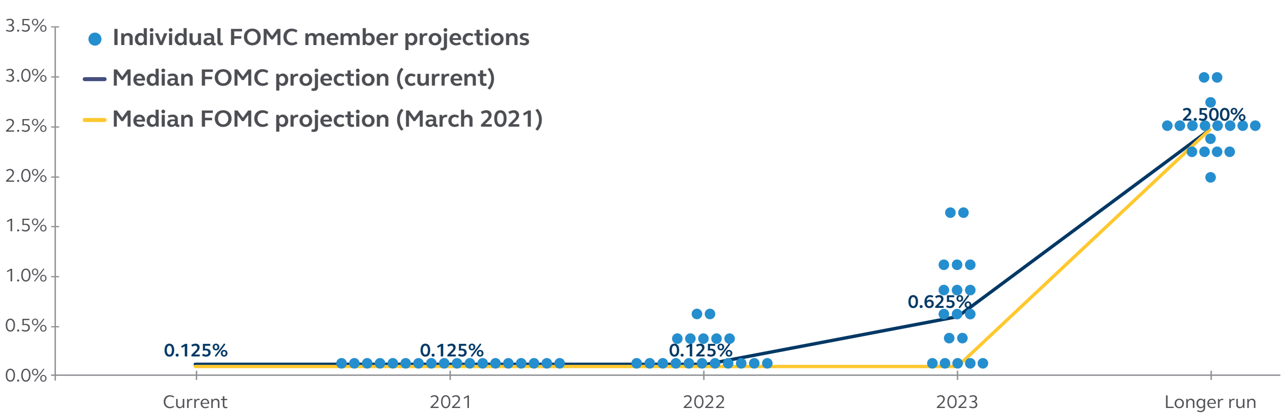
The median projection shown by the Fed's dot plot now depicts two rate hikes in 2023, up significantly from its previous projection of zero rate hikes until 2024. While this is more aligned with market pricing, the Fed's new projection wasn't accompanied by upward revisions to the 2022 and 2023 growth, inflation, or unemployment forecasts. This inconsistency has led markets to doubt the Fed's inflation tolerance, risking a more severe drop in inflation expectations and a sharp fall in long-term bond yields.

***Questions over central bank credibility aren't positive for risk markets.***

Yet, these recent dynamics are likely just a reflection of markets in transition. We expect 10-year bond yields to be drawn towards 2% by year-end, with Fed Chair Jerome Powell talking more transparently about tapering at the Jackson Hole conference in August, followed by formal discussions during the September Federal Open Market Committee meeting, and an official tapering kick-off in January 2022.

### FOMC federal funds rate dot plot

*Individual and median projections, percent, June 2021*




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

# **Macro insights:** Equities

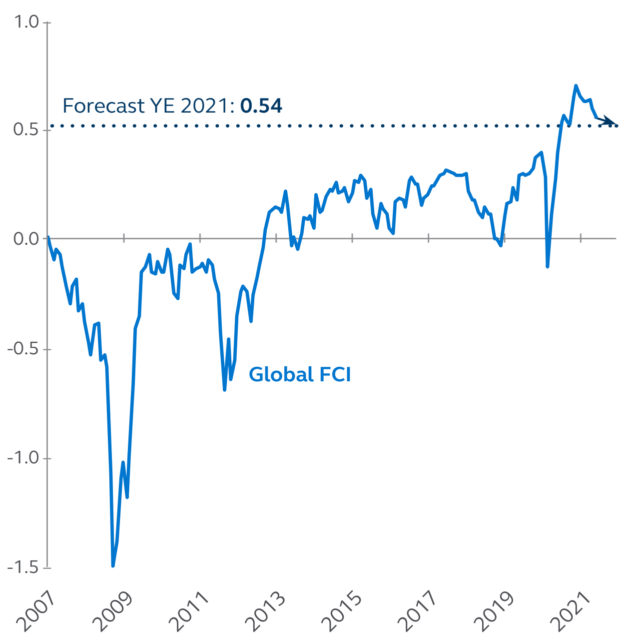
## Financial conditions continue to be easiest in recent history.

***With low rates and tighter spreads, there's no alternative to equities.***

Financial conditions, one of the best barometers for risk appetite at the asset allocation level and an important factor in interpreting equity market performance, remain extremely easy. While they've come in a bit more recently, conditions are at near-record levels—meaning it's about as easy for businesses to access capital as it's ever been. This environment is supportive of risk-taking, and combined with the challenging bond outlook, investment alternatives to equities are scarce.

**Global Financial Conditions Index**

*Z-score, 2007 – present, forecasted through 2021*




Source: Bloomberg, Principal Global Asset Allocation. Forecasted to year end 2021. Data as of June 30, 2021.

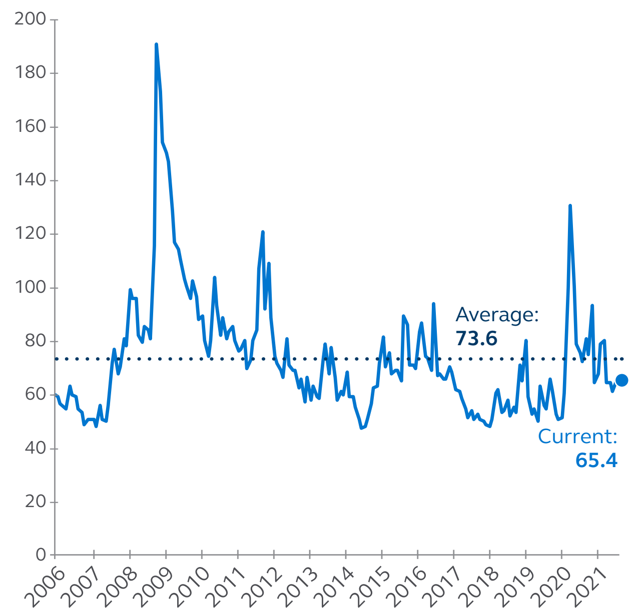
It's not just financial conditions and low rates fueling the appetite for risk assets. Tremendous fundamental improvement is forecast into 2022. The magnitude of the forecast earnings growth can be seen by looking at bottom-up consensus earnings data across asset classes. Though the base effects in the percentage increase from 2020 into 2021 have yet to normalize, valuations remain strong globally. And the 2022 outlook also remains positive, supporting the fundamental case for risk assets.

***Plenty of headline volatility, but little market volatility.***

While there's significant attention to volatility in the news, actual market volatility has remained relatively muted. The PGAA Cross Asset Realized Volatility Index, which spans across equities, fixed income, commodities, and currencies, is hovering near the lowest levels since 2007. So, concerns about the Fed tapering too soon and whether or not the global economy will achieve its lofty growth estimates certainly don't seem to be showing up in the markets, just in the headlines.

**PGAA Cross Asset Realized Volatility Index**

*Index, January 2006 – present*




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

***Peak equity valuations coincide with economic recovery…***

From a valuation standpoint, equity valuations are sitting near all-time highs almost universally and are priced with the assumption of a robust recovery and manageable inflation.

The U.S. remains our favorite region within a broader equity overweight. With most regions expensive, the U.S. stands out because it offers investors the ability to play both the reflation and deflation trade. That is, reflation through small cap exposure and deflation with mega cap positions. In a deflationary event, mega cap tech could continue its market leadership. At the same time, the U.S. has a healthy liquid market for playing the reflation trade with value-style equities—which have shown extreme performance patterns versus growth over the last several quarters.

### Equity returns and valuations

*Percent, LTM returns and % times cheaper, MSCI indices*

| | Index | |
|---|---|---|
| | LTM return (%) | % Time cheaper |
| MSCI Emerging Markets | 51.3% | 96% |
| MSCI All Country World | 41.9% | 99% |
| MSCI Brazil | 57.4% | 44% |
| MSCI China | 38.8% | 94% |
| MSCI EAFE | 36.9% | 99% |
| MSCI Europe | 40.6% | 99% |
| MSCI Germany | 40.0% | 91% |
| MSCI India | 67.0% | 93% |
| MSCI Japan | 24.8% | 75% |
| MSCI Russia | 35.9% | 64% |
| MSCI UK | 33.5% | 95% |
| MSCI USA | 45.0% | 99% |
| MSCI USA: Cap-structure | | |
| Large | 43.6% | 99% |
| Mid | 53.9% | 98% |
| Small | 66.0% | 98% |
| MSCI USA: Style | | |
| Value | 37.9% | 98% |
| Growth | 51.5% | 98% |

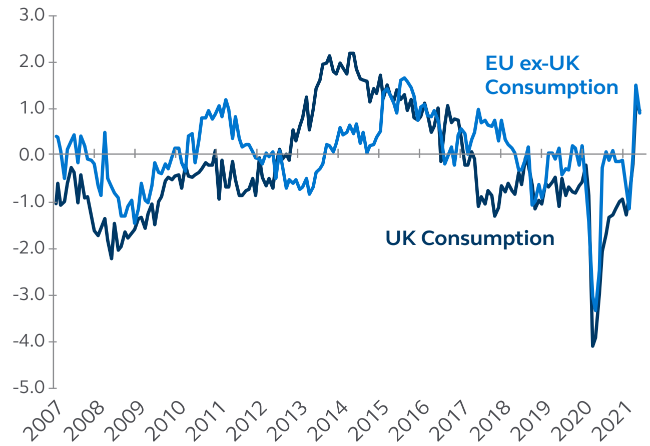
Source: Bloomberg, MSCI, Principal Global Asset Allocation. LTM (last twelve months) returns are total return and in USD terms. % Time Cheaper is relative to PGAA Equity Composite Valuation history. PGAA Equity Composite Valuation is a calculated measure, comprised of 60% price to earnings, 20% price to book and 20% to dividend yield. Composite started in 2003. Data as of June 30, 2021.

***Recovery continues to be de-synchronized.***

It's notable that we've seen a sharp upturn in European consumer data, both on the continent and in the U.K. Data shows sharp short-term upturns in activity as improvement in vaccine distribution takes place and an unlocking of pent-up demand occurs as consumers begin to spend. The staggered recovery should reach EM later this year as these supply bottlenecks begin to fade and vaccination rates increase. Structural challenges and sector compositions continue to keep us cautious on ex-U.S. developed markets. We're moving to an overweight of EM in anticipation of future recovery and realization of long-term structural advantages.

### PGAA Economic Activity Index

*Z-score, European Union ex-United Kingdom and United Kingdom, 2007 – present*




Source: Bloomberg, Principal Global Asset Allocation. The PGAA Economic Activity Index measures economic activity across trade, consumption, industrial output, and monetary policy. Data as of June 30, 2021

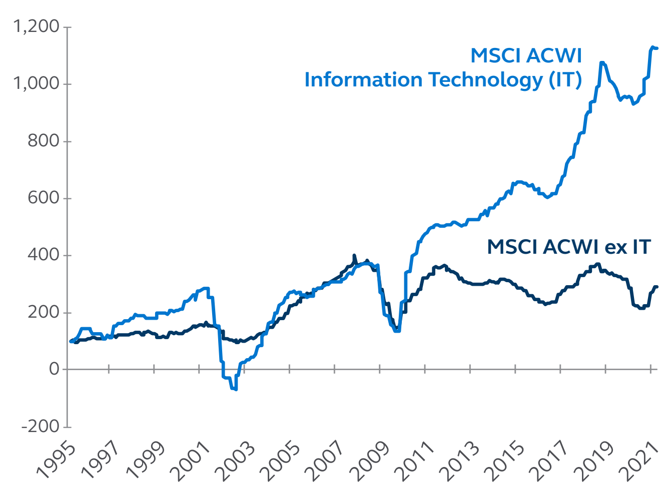
## Global earnings growth has been fueled by tech.

***The risk of not owning six U.S. technology leaders is high.***

When considering earnings growth, it's critical to highlight the path of earnings growth for global technology companies over the last 10 years. Starting in 2010, an incredible separation developed between the earnings of IT stocks and non-IT stocks, a split that's accelerated in 2021. While the cyclical recovery has fueled the upward movement of value, small cap, and other more cyclical stocks, earnings improvement and strong cash flow generation from IT remain the backbone of a secular growth trend.

### MSCI ACWI IT and MSCI ACWI ex IT

*Trailing 12-month earnings per share (EPS), Jan 1995 – present*




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

***Secular growth and cyclical value see-saw through 1H2021.***

Extreme style performance gaps have been a persistent feature of this market as growth and value investing have alternated market leadership. Over the past six quarters, the Russell 1000 style indices have posted six of the nine most extreme performance spreads since 2008. This shift in factor performance repeated as a global feature also seen in European markets, with value leading in 1Q 2021, while growth and quality factors dominated in 2Q 2021. We continue to advocate a balanced set of growth and value exposures: Use both secular tech and cyclical value trades to avoid unnecessary risk.

Easy financial conditions, strong fundamentals, and the outlook for economic growth supports a strong case for the continued outperformance of U.S. stocks, where both the secular mega cap growth trend and cyclical shift can reward investors. Positive consumer data and improved vaccine distribution are also creating opportunity in European equities.

# **Macro insights:** Fixed Income

## Uncertain outlook for growth challenges fixed income investors.

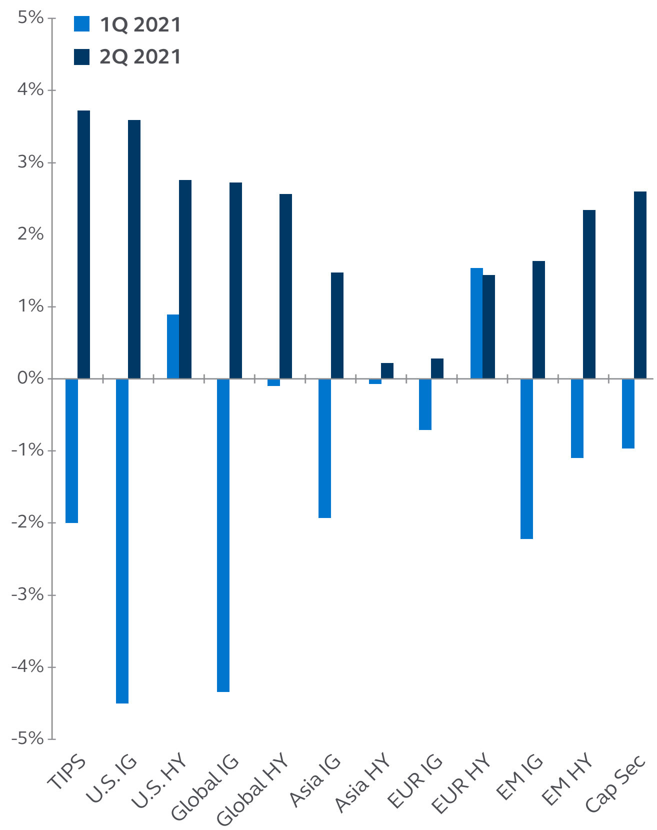
***The first six months of 2021 has been a tale of two halves.***

Despite equity markets, financial conditions, and COVID being the main headlines for the year, the fixed income markets haven't been spared. The bellweather Bloomberg Barclays Aggregate Index, a proxy for core fixed income, produced a -1.60% return in the first half of the year. Core bonds could potentially deliver a negative return for 2021, which would mark just the fourth negative calendar annual return in the past 45 years.

The first half negative return was primarily driven by the rate rise that took place in the first quarter. And indeed, it was a tale of two halves. In the first quarter, assets that are rate sensitive underperformed and delivered negative returns as rates moved up and optimism over cyclical recovery buoyed long-term rates. In the second quarter, however, as investors questioned the Fed's tolerance for inflation and concerns rose around the Delta COVID variant, long-term rates fell and fixed income assets performed far more positively.

**Return on select fixed income asset classes**

*Percent, 1Q 2021, 2Q 2021*




Source: Bloomberg, Principal Global Asset Allocation. See disclosure pages for index descriptions. Data as of June 30, 2021.

***Strong outlook for credit, though we expect rates to finish the year higher.***

Despite a decline in real rates, spreads have generally been cooperative in 1H 2021. Investment grade (IG) and high yield (HY) credit spreads have come in this year, but appear tight; we see potential for them to grind tighter yet. Massive fiscal and monetary stimulus at work in the economy tends to drive the lower quality ends of credit, rewarding risk-seeking in credit markets. In addition, the fundamental economic strength supports a case for credit.

We're forecasting Treasury yields to finish the year higher, near 1.9% by the end of 2021. The path forward is uncertain, but strong economic fundamentals point to a higher 10-year Treasury yield as investors also demand a higher term premium.

## Diversification within fixed income allocations is key to future returns.

***An "enhanced agg" can help optimize fixed income allocations.***

Investors continue to hear criticism of core bond allocations within a 60/40 allocation framework. One way investors have looked to improve fixed income allocations is to add a trio of up-in-risk credit options such as high yield, emerging market debt (EMD), and preferred securities to enhance return potential.

By introducing this new trio of credit assets, one's fixed income portfolio risk profile aligns more closely with equities and creates distance from interest rate risk. Credit risk adds total portfolio correlation to equities, but it also reduces total portfolio correlation to interest rates. In today's supportive environment for credit, featuring low rates, easy financial conditions, and stable markets, this type of fixed income portfolio enhancement approach is an attractive option to seek additional returns and yield.

***Sovereign bond yields have been lower for longer, a global phenomenon.***

One of the headline challenges affecting core fixed income investors are the historically low levels of interest rates available in global sovereigns. Low sovereign yields have caused investment headaches globally for income-focused investors. The global "thirst for yield" is part of the reason investors are moving toward higher volatility, higher income asset classes.

Interestingly, the long-term steady march higher in equity markets has been accompanied by a steady march lower in interest rates. Today, while equity valuations are near all-time highs, sovereign bond yields are almost universally near all-time lows. Going forward, when monetary and fiscal policy normalize, we expect more typical market dynamics to return. Rising real rate expectations and growing term premia would signal a shift.

### Local bond yields and valuations

*Percent yield and percent times cheaper, 10-year government bond yield for each country*

| | Index | |
|---|---|---|
| | Local yield (%) | % Time cheaper |
| Australia | 1.53% | 90% |
| Brazil | 9.09% | 86% |
| Canada | 1.39% | 87% |
| Chile | 4.40% | 76% |
| China | 3.09% | 79% |
| Germany | -0.21% | 90% |
| India | 6.05% | 88% |
| Indonesia | 6.59% | 87% |
| Japan | 0.06% | 79% |
| Korea | 2.10% | 82% |
| Mexico | 7.01% | 61% |
| Nigeria | 12.70% | 59% |
| Russia | 7.28% | 82% |
| South Africa | 7.37% | 89% |
| Switzerland | -0.22% | 82% |
| Taiwan | 0.79% | 98% |
| UK | 0.72% | 91% |
| USA | 1.47% | 93% |

Source: Bloomberg, Principal Global Asset Allocation. Global 10-year sovereign yields and % times higher than current. Data from June 2002 or inception date to June 2021. Data as of June 30, 2021.

# **Macro insights:** Base case scenario

Our base case is a "Goldilocks" scenario, where supply chain challenges fade and moderate demand helps to drive good growth conditions and moderate inflation pressure. However, inflation remains a key risk. Higher inflation from higher-than-expected demand could force the Fed to tighten sooner than expected, and de-synchronized global growth paths will continue to create supply side inflation pressure as not all countries are reopening at once. In this environment of easy financial conditions, we continue to expect market leadership from risk assets.

### The U.S. economy grows by 6.8% in 2021.

- Global cyclical upturn spreading in a staggered fashion as vaccine progress broadens.

### Fiscal policy is still supportive, but central banks become less accommodative.

- Fed to begin tapering in 1Q22 and raise policy rates mid-2023.

### Inflation pressures are building across most economies, driven by supply side dynamics.

- CPI inflation will fade slightly to 4.8% by the end of the year, settling in the 2 to 2.25% range in 2022.

### Financial conditions are still easy, providing support to risk assets.

- However, inflation and central bank fears will be disruptive to market dynamics.

### At this stage, we see three key risks that could disrupt our base case:

1. **Inflation expectations** become de-anchored as supply issues extend and firms pass costs to consumers.
2. **The Fed tightens policy** prematurely and risk markets struggle with tighter financial conditions.
3. **A growth scare** is triggered by additional waves of virus activity, resulting in bankruptcies and job losses.

These are the current views and opinions of Principal Global Asset Allocation and is not intended to be, nor should it be relied upon in any way as a forecast or guarantee of future events regarding particular investments or the markets in general.

# Investment outlook

## A deeper dive for investors and their portfolios

We remain constructive on risk assets, staying overweight equities, funded by an underweight to fixed income. Our neutral stand on alternatives reflects improved prospects for real assets and other up-in-risk categories, balanced against a tactical bias away from risk-reducing strategies.

### Key positioning changes over the quarter:

#### Equities

- Within a broader equity overweight, the U.S. remains our favorite region. The U.S. equity market features secular mega cap tech strength as well as cyclical opportunities in value and small cap.
- Improved consumer fortunes in Europe complete our preference for DM markets in aggregate.
- Emerging market equities have lagged YTD, but we believe the staggered recovery will reach EM later this year.

#### Fixed income

- We remain biased toward higher volatility spread assets, particularly high yield and emerging market debt.
- Conversely, we underweight low yield stability assets such as developed market sovereigns and U.S. mortgages.

#### Alternatives

- Our alternatives exposure falls into three distinct categories: return enhancers, asset classes like private equity and private debt; risk reducers, including cash and hedge fund-of-funds; and real assets, such as commodities and real estate.
- We remain overweight real assets and return enhancing alternatives. Risk reducers lack tactical appeal.

| Asset allocation | Investment preference | | | | |
|---|---|---|---|---|---|
| | Less | ← | Neutral | → | More |
| **Equities** | | | | ● | |
| **U.S.** | | | | ● | |
| Large Cap | | | | ● | |
| Mid Cap | | ● | | | |
| Small Cap | | | | ● | |
| **Ex-U.S.** | | ● | | | |
| Europe | | ◍ | ● | | |
| Japan | | | ● | ◍ | |
| Asia ex Japan | | ● | ◍ | | |
| Emerging Markets | | | ◍ | ● | |
| **Fixed income** | | ● | | | |
| **U.S.** | | | | ● | |
| Treasury | | ● | | | |
| Mortgages | | ● | | | |
| Investment Grade Corporates | | | ● | | |
| High Yield | | | | ● | |
| Preferreds (debt & equity) | | | ● | ◍ | |
| **Ex-U.S.** | | ● | | | |
| Developed Market Sovereigns | ● | | | | |
| Developed Market Credit | | | ● | | |
| Emerging Markets | | | | ● | |
| **Alternatives** | | ◍ | ● | | |
| Return Enhancing | | | | ● | |
| Risk Reducing | ● | | | | |
| Real Assets | | | | ● | ◍ |

● Current quarter's preference

◍ Previous quarter's preference (if absent, no change)

Source: Principal Global Asset Allocation. Alternatives asset classes include REITs, international real estate, MLPs, commodities, TIPS, multi-alternatives, and cash. Allocations across the investment outlook can be proportionately adjusted so magnitudes across categories do not have to net to neutral. Data as of June 30, 2021.

## Within our current investment outlook, we continue to see opportunities for investors across asset classes.

### Equities

A focus on U.S. small cap and secular mega-caps.

- Cyclical participation via small caps overweight
- Secular growth and strong fundamentals via mega cap exposure

**Consider implementing with:**

- Small cap strategies
- Mega cap exposure
- Large cap exposure

### Fixed income

Enhance core bonds with higher volatility asset classes.

- The duo of high yield and EMD appears attractive, supported by fundamentals
- We recommend a low duration bias

**Consider implementing with:**

- High yield strategies
- Emerging market debt strategies

### Alternatives

Pursue non-correlated real assets and return enhancers.

- Real return-focused strategies gain attractiveness when nominal growth slows
- Return enhancers with higher-than-average expected returns feature diversifying betas

**Consider implementing with:**

- Specialized real asset strategies
- Private real estate equity
- Global REITs

### Emerging markets

EM financial conditions expected to tighten more than developed markets, but opportunities lie below the surface.

- Overall, offers a hedge against DM political & macro risks
- EM credit offers attractive yield premium over DM credit

**Consider implementing with:**

- Emerging market equity strategies
- Unconstrained EM debt strategies

**Index Descriptions**

**Bloomberg Barclays Global Aggregate Bond Index** comprises global investment grade debt including treasuries, government-related, corporate, and securitized fixed-rate bonds from developed and emerging market issuers. There are four regional aggregate benchmarks that largely comprise the Global Aggregate Index: the US Aggregate, the Pan-European Aggregate, the Asian-Pacific Aggregate, and the Canadian Aggregate Indices. The Index also includes Eurodollar, Euro-Yen, and 144A Index-eligible securities and debt from other local currency markets not tracked by regional aggregate benchmarks. 

**Bloomberg Barclays Global High Yield Index** is a multi-currency flagship measure of the global high yield debt market. The index represents the union of the US High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices. The high yield and emerging markets sub-components are mutually exclusive.

**Bloomberg Barclays 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 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 Barclays 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.

**Bloomberg Barclays U.S. Treasury Bills 1-3 Month Index** is designed to measure the performance of public obligations of the U.S. Treasury that have a remaining maturity of greater than or equal to 1 month and less than 3 months.

**Bloomberg Barclays U.S. Treasury Inflation Protected Securities (TIPS) Index** is composed of inflation-protected U.S. Treasury bonds, commonly known as "TIPS". TIPS are securities issued by the U.S. Treasury that are designed to provide inflation protection to investors.

**EURO STOXX 50 Index**, Europe's leading blue-chip index for the Eurozone, provides a blue-chip representation of supersector leaders in the region.

**FTSE Global Core Infrastructure Index** is a market-capitalization-weighted index of worldwide infrastructure and infrastructure-related securities.

**FTSE NAREIT Equity REITS Total Return Index** is composed of U.S. real estate equities. The Index contains all Equity REITs not designated as Timber REITs or Infrastructure REITs.

**ICE BofA ML 10+ Year Treasury Index** is a subset of the Bank of America Treasury Master Index. The index measures the total return performance of U.S. Treasury bonds with an outstanding par that is greater than or equal to $25 million. The maturity range of these securities is greater than ten years.

**ICE BofA Emerging Markets Corporate Plus Index**, which tracks the performance of US dollar (USD) and Euro denominated emerging markets non-sovereign debt publicly issued within the major domestic and Eurobond markets.

**ICE BofA Euro High Yield Index** tracks the performance of Euro denominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets.

**ICE BofA Euro Investment Grade Index** tracks the performance of Euro denominated investment grade corporate debt publicly issued in the euro domestic or eurobond markets.

**ICE BofA ML Global Corporate Index** tracks the performance of investment grade corporate debt publicly issued in the major domestic and eurobond markets.

**ICE BofA ML US Inflation-Linked Treasury Index** is an unmanaged index comprised of U.S. Treasury Inflation Protected Securities with at least $1 billion in outstanding face value and a remaining term to final maturity of greater than one year.

**ICE BofA ML US Corporate Index** tracks the performance of US dollar denominated investment grade rated corporate debt publicly issued in the US domestic market.

**ICE BofA ML US All Capital Securities (i0cs)** index of preferred securities represents investment grade and below investment grade instruments in both the retail $25par market and the institutional $1,000par market.

**ICE BofA US High Yield Index** value tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market.

**JP Morgan EMBI Global Diversified Index** is an unmanaged, market-capitalization weighted, total-return index tracking the traded market for U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

**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.

**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.

**Nikkei 225 Total Return Index** measures the performance of the Nikkei 225 that includes both movements in the index level and reinvestment of dividend incomes from its component stocks.

**PGAA Global Cross Asset Class Vol**: Commodity, Equity, Currency and Fixed income implied volatility measures combined and rebased to 100 = 12/31/2002.

**PGAA Global Manufacturing PMIs**: GDP Weighted Country Purchasing Managers Indexes (PMI).

**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.

**Russell 2000 Index** is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

**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.

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