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2025 Perspectives

Optimism through the obstacles

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Table of contents

Executive letter 3
Macro 4
Equities 6
Fixed income 8
Multi-asset 10
Private Markets 12

Executive letter

KAMAL BHATIA, CFA
Chief Executive Officer

As we approach the fifth anniversary of the COVID-19 pandemic, the resilience of the global economy and market in that time has been quite remarkable. The global economy is 9.2% larger than it was pre-pandemic, the S&P 500 has doubled since the depths of 2020, and global unemployment has even fallen to below pre-pandemic levels. Yet, these impressive numbers mask the societal turmoil that originated from COVID and the policy responses that followed, which have driven fundamental political change throughout the globe this year.

Investors enter 2025 having to navigate these shifts. The transfer of wealth from the public sector to the private sector has led to great public indebtedness, adding to the "higher for longer" theme that the prior spike in inflation cultivated. Deglobalization continues to gather pace, contributing to global desynchronization and instability. The sharp increase in global liquidity has found its way into a handful of companies, but also neglected many, exacerbating both societal and asset class imbalances.

This backdrop of higher rates, higher volatility and lower returns demands more from active managers than ever before: the ability to navigate a broader opportunity set made up of both public and private markets to maximize returns; portfolio diversification to contend against elevated policy uncertainty, and local familiarity and understanding of global shifts. Underlying these requirements are forward-looking solutions and insights to help your investment goals.

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

MACRO

Resilient U.S. growth amid global uncertainties

SEEMA SHAH | Chief Global Strategist

The 2024 playbook was U.S. exceptionalism, decelerating global inflation, and central bank pivots—interspersed with bouts of severe political and geopolitical uncertainty. With the upheaval of the U.S. Presidential elections largely behind us, investors are re-focusing on the macro and policy backdrop.

U.S. strength remains undiminished, upheld by strong consumers and robust corporate balance sheets. This starkly contrasts European and Chinese weakness, which has continued to linger, despite policymakers stepping up stimulus measures. Next year, the macro backdrop will likely look like 2024, with U.S. outperformance still intact and the rest of the world attempting to navigate the obstacles that U.S. economic and political strength lays out for the global economy. That's not to say that the world won't benefit from U.S. strength—but it may present some challenges.

U.S. economic growth is set to remain above trend, at least in the first half of 2025. Broad household wealth remains near all-time highs. Solid gains in equities suggest that middle and higher-income households, which hold the bulk of assets and comprise 60-70% of U.S. consumer spending, remain in very solid positions. The overall corporate sector also remains strong, with high asset coverage and cash levels, suggesting ample buffers in the event of a revenue or cash flow squeeze. While the labor market showed worrying signs of weakness in the summer, more recent data paint a picture of strength. Prospects for deregulation under the new administration provide an important boost to business sentiment, reinforcing the constructive backdrop for the jobs market.

Yet, U.S. slowdown concerns have persisted. Lower-income households feel pressured by high rates and elevated prices (a key driving force behind the U.S. presidential election result). High wages and input prices are challenging small businesses, while interest rate-sensitive sectors such as construction continue to struggle.

Interest rate cuts would help those pockets of weakness. Yet, labor market resilience is rendering inflation's path back to the Federal Reserve's (Fed's) 2% target painfully slow and bumpy, and tariffs and restrictive immigration policies threaten a pick-up in price pressures in 2025. As such, a significant and aggressive monetary policy easing has become increasingly difficult to justify.

> "**U.S. strength remains undiminished**, upheld by strong consumers and robust corporate balance sheets, contrasting sharply with European and Chinese weakness."

Furthermore, with the Fed's re-evaluation of the neutral policy rate leaning towards a higher rate, the central bank will likely become increasingly cautious about its easing path. The key implication of all this is that, come early 2025, rather than reducing policy rates at each meeting, the Fed is likely to slow its cutting pace to every other meeting—with some risk that rates don't fall as far as either the Fed or the market initially envisioned. What started as a central bank pivot has evolved into a central bank swerve. Unfortunately, interest rate relief will likely be shallow and restricted for U.S. pockets of weakness, exacerbating the bifurcated U.S. economy.

Meanwhile, China's growth is set to underperform once again. The bleak outlook remains rooted in a vicious cycle of deflationary risks, high unemployment, consumer caution and property market weakness. And now, with U.S. President-elect Donald Trump's threat of a sharp rise in tariffs, the desperate need

for policymaker support is painfully clear. High hopes for a policy stimulus bazooka have faded, but fiscal expansion should at least put a floor under economic weakness.

Similarly, the juxtaposition of U.S. strength and European economic anemia will be exacerbated in 2025 if the incoming Trump administration's threats of a universal tariff come to fruition. Stagnant economic growth implies continued disinflation, potentially pushing inflation below-target in 2025. The European Central Bank must cut more than the Fed, taking policy rates below their neutral level.

The offset of these global crosscurrents is a modest global growth slowdown, policy desynchronization, and a strong U.S. dollar—a potentially adverse environment for emerging markets. Tech strength in pockets of Asia, and continued Indian economic dominance, may counteract some of the downward forces.

What are the risks ahead? Policymaker error, either from central banks or the government. The difficulty of accurately estimating the neutral rate, particularly at a time of profound technological change, means that as monetary easing cycles progress, the risks mount. Central bankers will need to navigate the future environment with care. Governments also need to tread cautiously. Bond vigilantes are steadily gathering and further expansion of government spending, particularly if an economy needs no further stimulus, risks the ire of markets. Finally, the range of policy changes the new U.S. government has proposed, particularly on the trade front, renders the global outlook increasingly uncertain.

Navigating 2025 against this backdrop of elevated uncertainty, dispersion, and potential global friction will be demanding. The opportunities for investors are plenty, but so are the obstacles.

EQUITIES

Opportunities in economically sensitive sectors amid strong U.S. growth

GEORGE MARIS, CFA | Chief Investment Officer, Global Equities

Improving economic conditions, growing corporate earnings, solid balance sheets and favorable credit conditions provide a constructive backdrop for global equities. Liquidity is a critical factor to note as ample liquidity was a key driver of asset strength in 2024. Monetary and fiscal-driven liquidity helped drive equity returns, as evidenced by multiple expansion and tightened credit spreads. Entering 2025, the world's three largest economies (the U.S., China, and the EU, collectively representing nearly 60% of global GDP) are all signaling stimulative policy actions. Unless derailed by inflation or geopolitics, the easy liquidity backdrop should support market returns.

There are several reasons to be optimistic. U.S. policy may spur additional economic growth as the incoming administration and Congress signal a push for broad deregulation and lower corporate and individual taxes. This should spur improved domestic capital formation, durables consumption and M&A activity. While policy implementation is still to be determined, the bias appears incrementally more pro-growth. The tax reductions may pressure federal deficits, but some of this pressure may be offset by the degree of the new administration's success in addressing bureaucratic inefficiencies. Success here would support a steady stream of government-led pro-growth initiatives.

Given this environment, opportunities will likely arise in companies residing in economically sensitive industries and overlooked sectors. There are many examples of companies generating resilient free cash flows trading at attractive valuations across various economically sensitive sectors, including materials, capital goods, consumer cyclicals and financials. The resilient but out-of-favor health care sector could experience improved breadth driven by greater M&A in response to recent market conditions. This backdrop also bodes favorably for small-and mid-capitalization stocks, which quietly outpaced the long-dominant large-caps in the latter half of 2024, yet still offer historic relative valuation discounts.

The continuing pace of innovation is another reason for optimism, particularly in high-end computing and life-sciences. Innovation is growth-stimulative and disinflationary due to its impact on productivity. Artificial Intelligence is early in its usage but offers great promise across many practical applications, including software development, agriculture, finance and healthcare. The investment needed for AI deployment is historically massive and shows no signs of abating. In healthcare, new weight loss treatments offer the ability to systematically address one of the greatest co-morbidities. This should improve lifespans and result in a net reduction in societal healthcare costs. Continued therapeutic customization also continues to grow, offering additional measures to improve the quality of life.

> "**Innovation is growth-stimulative** and disinflationary due to its impact on productivity, with AI offering great promise across industries."

The preceding are powerful forces supporting equity returns in the coming year. Yet, with the S&P 500 trading at 22x on $269 consensus EPS, representing approximately 12% anticipated growth, U.S. earnings growth needs to deliver given the bullish sentiment as evidenced by historically elevated broad market valuations.[1] Nothing on the horizon is raising broad warning flags, but vigilance is needed as disappointments will be punished amid the current high expectations.

[1] As of December 5, 2024.

From a global perspective, there is a notion the U.S. drove all the performance in equity markets while international stocks languished. This is not entirely accurate. Some of the strongest markets over the last several years— keeping pace with U.S. growth stocks—are India and Japan. Indian equity performance was a function of flows out of China and in response to improving sovereign and corporate governance leading to improved growth. Japanese equity results were driven by broad corporate reform and governmental commitment to end deflation.

While numerous challenges and risks persist—most notably ongoing economic weakness in Europe and parts of Asia—the depressed valuations in these regions create attractive entry points for long-term investors in firms generating resilient economic returns. Both China and the UK are examples of countries facing longstanding economic structural issues, and it's not surprising that investors view companies domiciled in these markets with pessimism. Nevertheless, the market pessimism seems extreme as many of these companies operate globally yet are beset with deeply discounted valuations relative to their own histories and global peers.

Despite the constructive market backdrop, bursts of volatility seem inevitable and aggregate market volatility may trend higher. The technical sensitivity of the market and global liquidity is exemplified by the sharp global sell-off in early August of 2024. The turmoil was sparked by a modest policy shift by the Bank of Japan, which raised rates to strengthen the beleaguered Yen. As predictable as this action was, it still ignited a concentrated wave of trading across currencies, bonds and equities amid rapid deleveraging due to an unwind of the Yen-carry trade. For better or worse, the explosion of cheap and leveraged trading creates concentration risks that may destabilize markets. While this can lead to short-term disruptions, the reactions are often indiscriminate from a bottom-up perspective. For discerning long-term fundamental investors who can use liquidity and volatility to their clients' advantage, today's markets can create opportunities.

As investors position themselves across global equities, they do so amid attractive fundamentals and constructive policies. These forces should underpin earnings growth and drive market sentiment resulting in improved breadth across sectors and regions.

FIXED INCOME

Navigating yield opportunities amid heightened inflation uncertainty

MICHAEL GOOSAY | Chief Investment Officer, Global Fixed Income

Investors are entering 2025 at a fulcrum point for global fixed income markets. On the U.S. monetary policy side, the FOMC's desired path towards lower policy rates has been complicated by resurgent inflation expectations fueled by the outcome of the U.S. election and a surprisingly resilient economy. On the U.S. fiscal side, an unexpectedly convincing victory by President-elect Trump and a Republican sweep of Congress has injected renewed uncertainty into the depth and degree of forthcoming policy changes. Outside the U.S., a divergence in central bank policy is emerging across the G4 banks (the Federal Reserve, European Central Bank, Bank of England and Bank of Japan), creating pockets of countervailing global economic forces.

So, what does this mean for fixed income investors in the year ahead? In short, heightened uncertainty breeds opportunity—and fixed income markets should be brimming with opportunity in 2025. With so much prospective noise on the horizon, fixed income investors need to identify the signal and relative value that will deliver over the long term, and focus on two major factors when assessing what will drive fixed income performance in the year ahead: starting yield levels and credit spread dynamics.

Starting yield (income) levels

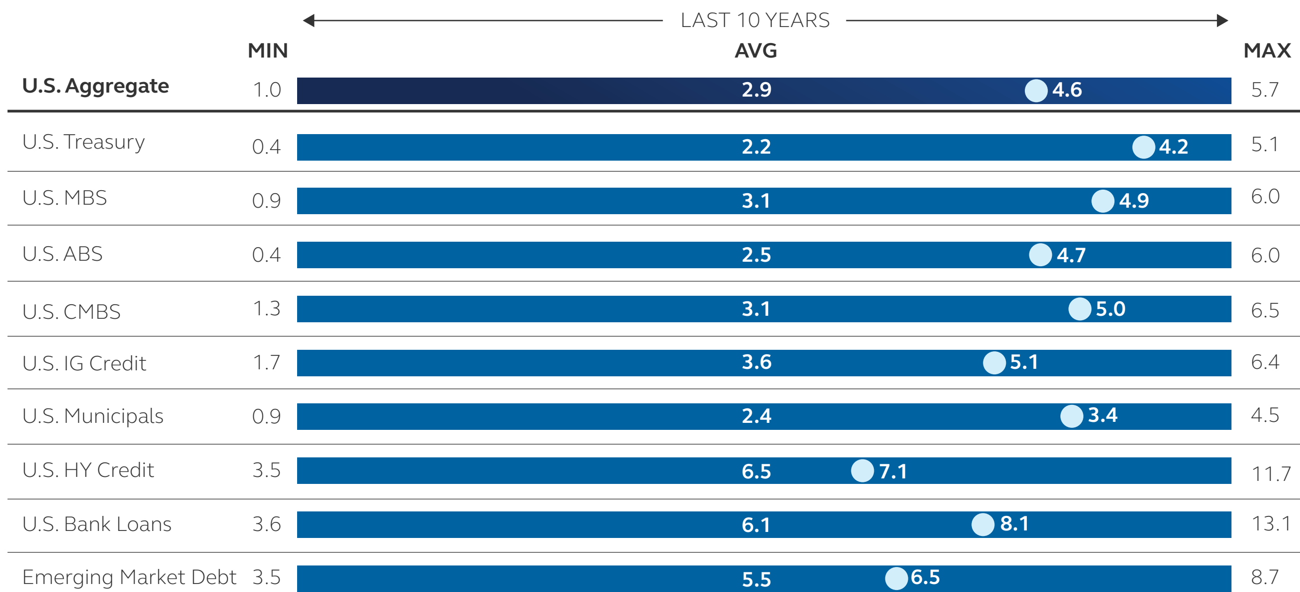
Assuming President-elect Trump follows through on his "promises made, promises kept" mantra, there will likely be early upward pressure on inflation through the swift enaction of tariffs and pursuit of tax cuts. This, in turn, would complicate the FOMC's quest for price stability and the path for lower policy rates. Given the FOMC's steadfast commitment to data dependency, any notable resurgence in inflation—alongside an unwavering U.S. economy—will likely lead to a pause or more tepid pace of policy adjustments. In the end, heightened inflation expectations should lend itself to continuing elevated yield environment in early 2025. However, we still believe the longer-term path of rates is more likely lower versus higher and anticipate duration (or interest rate sensitivity) will be a tailwind for fixed income investments over the course of 2025.

> "**Fixed income investors should consider the early 2025 rate environment a unique entry point** to capture attractive starting yield levels and mitigate reinvestment risk."

Fixed income investors should consider the early 2025 rate environment a unique entry point to capture attractive starting yield levels, extend duration and mitigate reinvestment risk. With a greater likelihood for the lasting path of front-end rates to be lower versus higher, increasing duration now will better position a portfolio to take advantage of falling rates. Coincidentally, increasing duration will reduce the risk that an investor sitting in cash and cash equivalents today will have to reinvest that money at a lower rate by locking in yield for a longer period. As the year progresses, high-quality, longer-duration fixed income should outperform on a risk-adjusted basis as the inverted yield curve steepens and an economic slowdown becomes more apparent. Fixed income instruments with more duration should benefit as yields on the front end of the curve fall below the yields on the long end of the curve. Holding investment-grade paper should better position portfolios to weather an economic downturn and help reduce default risk.

Fixed income yield levels

Yield to worst, last ten years



Source: Bloomberg, Principal Fixed Income. Data as of November 30, 2024. Min, max, and average based on last 10 years. Weighted average yield-to-maturity reflected for U.S. Bank Loans. Indices are unmanaged and do not take into account fees, expenses, and transaction costs, and it is not possible to invest in an index. See disclosures for index descriptions.

Credit spread dynamics

Credit spreads will likely remain rangebound, with a modest widening bias, over the course of 2025. With tight spreads, our appetite for outright "risk-on" positioning entering the new year is muted, and yields and carry should remain attractive. The decisive outcome of the U.S. election acted as a risk-clearing event and a positive development for credit markets by alleviating concerns over a prolonged and contested decision. We held a positive outlook for investment-grade and high-yield credit leading into the election. Following the results, conviction was maintained in select investment-grade and high-yield credit opportunities. This thesis is underpinned by stable corporate fundamentals and attractive yields, which bolster an already strong technical backdrop. If rates remain somewhat elevated, yield buyers should continue to view corporate bonds as an attractive asset class. The immediate post-election rally in risk assets—of which credit markets are a part—reflects the projected pro-growth agenda and higher-for-longer rates thesis. Moderating supply into year-end also makes the supply/demand equilibrium picture look good heading into 2025.

The Financial and Energy sectors should benefit from anticipated deregulation and pro-growth policies under a Republican-led government. Overall, tariffs (higher), taxes (lower), and corporate regulation (looser) policies are the key market drivers following the election. On the flip side, the Utility sector could face negative headwinds under a Trump administration, as lower taxes might negatively affect regulated utilities. Moreover, the Pharmaceutical, Building Materials and Retail sectors are most exposed to a potential tariff spike.

Looking ahead

All told, investors should be excited about the opportunities that await fixed income markets in the year ahead. While the heightened uncertainty and episodic volatility may endure, this will likely create ample opportunities for fixed income investors. With a prospective environment of gently slowing economic growth and monetary easing, exposure to fixed income remains prudent for investors. Fixed income assets provide a reliable source of income and yield, offer mitigation against widespread market volatility, and present opportunities to enhance returns within investment portfolios.

MULTI-ASSET

Risk-on, but with conditions attached

TODD JABLONSKI, CFA | Chief Investment Officer, Multi-asset & Quant Strategies

Many global multi-asset investors are approaching 2025 with some trepidation, and the growing unease is understandable. The list of significant concerns is long: U.S. economic growth is slowing; open conflict continues in the Middle East and Europe; the Fed is early in a delicate easing cycle; the market presumes cooperative disinflation, and to top it off, many asset classes are priced at sky-high valuations! Plus, sharply different policy is expected in the forthcoming Trump administration. All told, we expect market volatilities to increase in 2025 and see the same rising risk tides (more on that later.)

Meanwhile, thinking about the return side of the coin, U.S. equity investors enter 2025 having enjoyed a fantastic run of performance in 2023 and 2024. The S&P 500 has delivered a whopping +52.7% total return from year-end 2022 to month-end October 24, an impressive outburst of performance, driven more than anything by AI spending boom expectations. Looking at their history, U.S. equity markets have been cheaper 94% of the time compared to current levels. Ex-U.S. equities, on the other hand, are relatively less expensive, but remain rich versus their history, being cheaper 72% of the time as of month-end October 2024. Simply put, bargains are hard to find.[2]

How should multi-asset investors approach an uncertain 2025?

We approach the year with optimism for equities, credit, and risk assets. While our risk appetite has diminished from the past several years, we retain a slight equity overweight and see a path to a rewarding 2025. Fundamentals (global earnings expected +13% in 2025, +15% in the U.S.), technicals and even valuations support the case for a modest risk-on positioning.

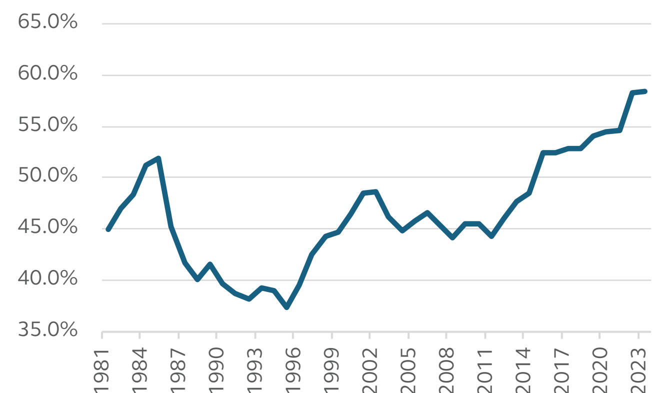
However, several conditions are needed for this optimistic view to hold water.

First, the market has priced in a couple key assumptions: the U.S. will avoid real recession, and the soft-landing path must continue for valuations to stay high. Second, there can't be a reacceleration of inflation, which would impede central banks' ability to cut policy rates and delay/scale back the expected synchronized global easing cycle.

Macro: Today's macro investing outlook is predicated on the U.S. growth outlook. U.S. GDP is now estimated to be near 60% of G7 GDP, and the U.S. stock market is expected to account for 65% of global equity capitalizations. Executing a soft landing isn't easy—Inflation can't be too high, and growth can't be too slow. It's usually recessions that kill market rallies, so investor focus must remain on cyclical indicators. Our base case calls for several Fed policy rate cuts in 2025, generally cooperative inflation, and improving global financial conditions.

U.S. share of G7 GDP

1981–present



Source: Bloomberg, Principal Asset Allocation.
Data as of December 31, 2023.

Multi-asset return outlook: Barring a recession, U.S. equities could very well produce a +10% gain, and core U.S. fixed income could return +5-7% in 2025, with a slight decline in the 10-year Treasury yield. Credit spreads, while narrow, should continue to hold income appeal and remain durable. A globally diversified multi-asset strategy will likely have less return in 2025 than in 2024, but we still expect a solid year.

Multi-asset risk outlook: Risk will likely rise in 2025. Equity markets were historically quiet in the first half of 2024 and only achieved median levels of volatility in the third quarter. Meanwhile, fixed income returns have been quite volatile in 2024 as investor speculation about the size and pace of central bank cuts drove interest rate volatility. We anticipate that currency risk will similarly rise next year alongside rate risk, further muddying the landscape. Across our multi-asset portfolios, we're positioned for increased volatility in 2025 relative to 2024, as equities are unlikely to remain so well-behaved amid an uncertain soft-landing execution.

Multi-asset correlation outlook: Picking on the 60/40 portfolio, and multi-asset concepts in 2022 was popular when the venerable 60/40 strategy produced a -15.8% total return. The stock/bond correlation ran high that year at +0.27. Fast forward to 2024, and the year-to-date correlation through November 6 has fallen to a mere +0.08, indicating virtually no correlation between the two series! Measures beyond stock/bond have also indicated divergent performance, with real assets, stability assets, and growth assets showing their natures in 2024. The power of diversification improved in 2024, and we expect correlations to stay low/well-behaved in 2025.

"**Equities, credit, and risk assets remain attractive** for 2025, supported by solid global earnings growth and improving financial conditions."

[2] Source: FactSet, Bloomberg, MSCI, Principal Asset Allocation. As of October 31, 2024.

PRIVATE MARKETS

Gaining investor focus for good reason

TODD EVERETT | Global Head of Private Markets

In sailing terms, maneuvering to clear air is a priority in any conditions, but it's even more important in light winds. Is investor interest in private market solutions the "tacking strategy" to find clear air in a less than certain economic environment, to accelerate returns, or to optimize portfolio performance? Much has changed over the last year, with recent developments and market factors pointing to "yes." Among these factors are:

- The cost of leverage, a significant factor in private market investment, has likely peaked.
- Material adjustments (+/- 20%) in private market real estate valuations have already occurred, excluding office, which is considerably lower.
- Whether due to a resilient economy and slowing construction activity (real estate) or societal need and government support (infrastructure), private market fundamentals are on solid footing.
- Underwriting standards and private market valuation assumptions across the sectors, are leaning more towards cyclically conservative versus peak-of-market.
- Traditional private market lending sources (commercial banks) have ceded ground, allowing new leverage providers in the direct lending and real estate market with a stronger focus on delivering solutions to the institutional and wealth channels to secure excess value.

Resiliency, which translates into lesser volatility plus lower correlation with stocks and bonds combined with stronger risk-adjusted returns, is the primary reason for investors to consider sacrificing liquidity and venture into private market options.

We believe the private market sectors should deliver improved or steady performance in our base-case economic scenarios in 2025. Even in a less-than-ideal future environment, the current positioning of the private market sectors (real estate, infrastructure, alternative credit, and asset-backed lending) could provide some softening in negative or tail risk outcomes.

> "**Resiliency in private markets** translates into lesser volatility, lower correlation with stocks and bonds, and stronger risk-adjusted returns."

The Fed's policy action in September buoyed the private markets by improving sentiment and activity. However, market expectations for future reductions may need to be recalibrated. The 10-year Treasury yield remains a key element to watch (specifically for real estate), rangebound (maximum of 4% to 4.5%) would be a tolerable result. An attentive approach is required; however, there is reason for increasing allocations in the private market sectors. The private market attributes of value, diversification, correlation, stability, and underlying real asset support should all be alive and well in 2025, providing the "clear air" accelerates results through additional allocations.

Private Market Sector	State of Market (Asset Valuation)	Fundamental Highlights	Other Rationale and Key Risks	Outlook and Conclusions
Commercial Real Estate Equity	Valuations appear to have bottomed, with transaction pricing down by 20% to over 40% for the office property type. End of Fed rate hiking cycle has brought about a sense of normalization, with signs of increasing transaction activity and price discovery.	Vacancy levels (excluding office) in equilibrium. Construction deliveries to slow. Leverage in rent negotiations returning to landlords in 2025-2027. Data centers have unprecedented demand from tenants/users and investors.	Resiliency in the labor market and consumer spending are drivers of demand. Improving capital flows expected in both the equity and debt markets in 2025. **Key risks:** The market is still not fully repriced for either a recession or a lofty 10-year Treasury.	The market has likely bottomed, and total returns are expected to improve in 2025; however, it's likely to be an uneven recovery and perhaps not at previous levels Returns are unlikely to gain material support from a return to a historically low cost of debt, but fundamentals are expected to improve. Compelling opportunities in buying below replacement costs and select development opportunities.
Commercial Real Estate Debt	Adjusted state, as outlined in CRE equity above.	Strong as outlined in CRE equity above. Less traditional banking competition. LTVs and debt yields provide risk mitigation.	Excessive leverage in the system and over-engineering in the capital markets (such as with the GFC) is not present. **Key risks:** Stagflation or deep recessionary conditions.	Higher yielding (moderate risk) real estate debt will continue to compete well with core real estate equity in total return performance and predictability in 2025. Relative value proposition over public alternatives is above average.
Private Infrastructure Equity	Essential infrastructure assets benefit from favorable macro tailwinds and overall attractive valuations, as well as low volatility. Historically low correlation to traditional equities provides for counter-cyclical investment opportunities.	Strong sector fundamentals driven by global needs across digital infrastructure, power and energy, transportation and social infrastructure assets.	Continued global investment needs across core and core+ infrastructure sectors. Core infrastructure sectors such as renewable generation are seeing higher valuations given supply/demand imbalances.	Attractive opportunities in Private Infrastructure Equity will continue to augment alternative real asset equity strategies.

Private Market Sector	State of Market (Asset Valuation)	Fundamental Highlights	Other Rationale and Key Risks	Outlook and Conclusions
Private Infrastructure Debt	Attractive risk adjusted returns with a long-term investment horizon supported by long asset lives that provide essential services with low demand elasticity and monopolistic characteristics. Investments support critical financing needs and benefit from overall favorable policy support.	Strong fundamental secular tailwinds globally, including digitalization and growing energy needs, decarbonization and sustainability and demographic trends supporting the continued need for substantial capital investment needs.	The sector maintains lower default rates and higher recovery rates than similar non-financial corporate debt. **Key risks:** Certain renewable and power sectors have larger investment demand than financeable projects, compressing deal margins.	Relative value proposition over public alternatives remains strong and provides portfolio diversification. Opportunities for non-bank lenders to support infrastructure financing where traditional banks withdraw due to regulatory constraints increases the investable opportunity set.
Private Corporate IG Debt	Very strong valuations as borrowers continue to pay for execution assurance, leading to YTD issuance up ~20% y/y.	Meaningful covenant discipline exists, with >80% of deals assessed having average or above-average packages.	Deferral fundings are still required for most transactions, but the share has fallen below 5yr average.	Highly diversified, high quality, global allocation diversifying away from Financials into core Industrials will continue to drive allocations.
Private HY Yield Credit/ Direct Lending	After declining in 2022 and 2023, Enterprise Value (EV) multiples are expanding with lower rates and some economic clarity. Yield/spread valuations have compressed from extremely attractive levels in 2023. Yield/spread premium to public high yield bonds and broadly syndicated loans remains significant.	Suitable credit structures with reasonable leverage remain the standard. Terms have weakened some for the upper middle market as it competes with public markets. Observing some increase in the level of payment-in-kind (PIK) offered by lenders in larger transactions. Default and loss levels remain below long-term average.	Lower and core middle market continues to provide spread premium and structural protection (covenants, tighter terms, etc.) compared to upper middle market. **Key risks:** Deep recessionary conditions. Moderate increase in non-accrual/default rates toward long-term average levels of 2-2.5%.	With greater clarity around economic conditions and the Fed's path, expect LBO/M&A activity to increase along with capital deployment. Risk premiums likely to remain in current range - some potential widening with macro condition uncertainty and greater deal flow. Even with floating rate nature, expect yields to be hold above 10%. Relative value to comparable public bonds/loans remains above long-term average.
Asset-Backed Lending	Valuations are attractive as evolving bank regulatory changes and consolidation have created meaningful sourcing opportunities.	Household debt service as % of total disposable income best level in 4 decades, with borrower delinquencies remaining relatively stable.	Credit delineation between near and subprime will become more important as income inequality manifests and facility attachments will drive outcomes.	Short-duration, high-touch lending opportunities continue to create meaningful flexibility for managers to rotate and flex into and away from asset class.

Where to best access private market sector values

REAL ESTATE EQUITY

The best values remain in strategies with heavy weightings to the resilient (residential, industrial) and thematic (data centers, cold storage) property types. Grocery-anchored retail could outperform. While core returns should improve, value-add and development in the favorable sectors may be especially appealing. Structured investments such as preferred equity could provide attractive risk adjusted returns. While tempting, office dislocation remains a complicated opportunity.

REAL ESTATE DEBT

Based on risk-adjusted returns, there is a solid lean into real estate debt, especially light-to-moderate risk bridge lending, select construction, and participating construction. Favored property types remain preferred.

PRIVATE INFRASTRUCTURE EQUITY

Favorable macro tailwinds support attractive risk adjusted returns and portfolio diversification objectives. Private infrastructure equity is well poised to support strained government balance sheets globally and support investment needs in core infrastructure sectors, including energy, power, digital investments, transportation, and social infrastructure.

PRIVATE INFRASTRUCTURE DEBT

Beneficial macro and industry megatrends across key sub-sectors, including digital infrastructure (data center, fiber, telecom); power and energy (renewables, decarbonization, energy storage) and transportation (ports, airports, rail, roads) are driving increasing investment needs and appetite from investors. Investment benefits include higher risk adjusted relative value over public alternatives. These long-life assets benefit from more stable and predictable cash flow, as well as collateral and/or covenants that provide downside mitigation and overall favorable policy support.

PRIVATE IG CREDIT

Value continues to exist in transportation (U.S. and global), technology (media/sports), and food services. Unlevered spreads exceed IG public expected return premium of +30bps.

PRIVATE HIGH YIELD CREDIT/DIRECT LENDING

The value of middle market direct lending (MMDL) has become more appealing, with public market risk premiums compressing significantly. Within MMDL, the lower middle market and select core middle market opportunities maintain discipline, require covenants and reasonable leverage, and achieve attractive risk premiums. A focus on more resilient industries should support more favorable returns, as economic conditions will remain uncertain for some time. In addition, we believe first lien senior secured exposure within the debt capital stack continues to be attractive relative to non-senior exposure such as mezzanine debt. As Secured Overnight Financing Rates decline, non-senior exposure may become more appealing if the economic conditions and outlook become clearer and more constructive.

ASSET BACKED LENDING

Best values likely remain in strategies tilted towards residential (high quality/non-qualifying mortgages) followed by specialty (data center/NAV/fund leverage), commercial lending (transportation, equipment & fiber) and consumer (installment, point of sale). Unlevered net returns are still very attractive in the mid-teens across both whole loan and facility (IG/unrated) lending.

Fixed income yield chart index descriptions:

The Bloomberg U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

The Bloomberg CMBS ERISA-Eligible Index is the ERISA-eligible component of the Bloomberg CMBS Index. This index, which includes investment grade securities that are ERISA eligible under the underwriter's exemption, is the only CMBS sector that is included in the Bloomberg U.S. Aggregate Index.

The Bloomberg Asset-Backed Securities (ABS) Index has three subsectors: Credit and charge cards, Autos, Utility. The index includes pass-through, bullet, and controlled amortization structures. The ABS Index includes only the senior class of each ABS issue and the ERISA-eligible B and C tranche. The Manufactured Housing sector was removed as of January 1, 2008, and the Home Equity Loan sector was removed as of October 1, 2009.

The S&P/LSTA (Loan Syndications and Trading Association) Leveraged Loan 100 Index is designed to measure the performance of the U.S. leveraged loan market based upon market weightings, spreads, and interest payments. The index is composed of loans bought by institutional investors that have partnered with S&P Global Market Intelligence's Leveraged Commentary & Data (LCD). Index constituents are market-value weighted, subject to a single loan facility weight cap of 2%.

Bloomberg U.S. Corp HY 2% Issuer Capped is the 2% Issuer Cap component of the U.S. Corporate High Yield index. The Bloomberg U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

The Bloomberg U.S. Credit Index is the U.S. Credit component of the U.S. Government/Credit index and includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

The Bloomberg U.S. Treasury Index is public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Bloomberg U.S. MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates.

The Bloomberg U.S. Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market.

The J.P. Morgan EMBI Global Diversified Index (EMBIGD) tracks liquid, US Dollar emerging market fixed and floating-rate debt instruments issued by sovereign and quasi-sovereign entities1. The index was launched in July 1999 with daily historical index levels dating back to December 1993. Historical to-maturity and to-worst statistics are available from December 1997 and December 2001, respectively.

Risk considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed. Asset allocation and diversification do not ensure a profit or protect against a loss. 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. Equity investment options involve greater risk, including heightened volatility, than fixed-income investment options. Fixed-income investment options are subject to interest rate risk, and their value will decline as interest rates rise. Real estate investment options are subject to risks associated with credit, liquidity, interest rate fluctuation, adverse general and local economic conditions, and decreases in real estate values and occupancy rates. Infrastructure companies may be subject to a variety of factors that may adversely affect their business, including high interest costs, high leverage, regulation costs, economic slowdown, surplus capacity, increased competition, lack of fuel availability, and energy conservation policies. Investments in private debt, including leveraged loans, middle market loans, and mezzanine debt, are subject to various risk factors, including credit risk, liquidity risk and interest rate risk. Fixed-income investment options that invest in mortgage securities, such as commercial mortgage-backed securities, are subject to increased risk due to real estate exposure. Private credit involves an investment in non-publicly traded securities which are subject to illiquidity risk. Portfolios that invest in private credit may be leveraged and may engage in speculative investment practices that increase the risk of investment loss. Terms, conditions, fees, expenses, pricing and other general guidelines and provisions are subject to change. As a general matter, commercial mortgage lending entails a degree of risk that is typically only suitable for sophisticated institutional and professional investors for whom such an investment is not a complete investment program and who fully understand and are capable of bearing the risks associated with such strategy. Commercial mortgage lending is subject to the basic risk of lending and direct ownership of commercial real estate mortgages -borrower default on the loan and declines in the value of the real estate collateral. Defaults can be complicated by borrower bankruptcy and other litigation including the costs and expenses associated with foreclosure which can decrease an investor's return. Declines in real estate value can result from changes in rental or occupancy rates, tenant defaults, extended periods of vacancy, increases in property taxes and operational expenses, adverse general and local economic conditions, overbuilding, deterioration in the physical condition of the asset, environmental issues at the mortgaged property, casualty, condemnation, changes in zoning laws, taxation and other governmental rules. Commercial mortgage investments are also very dependent on the financial health, operational expertise, and management skills of the borrower.

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