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Principal Equities

Principal Asset Management[SM]

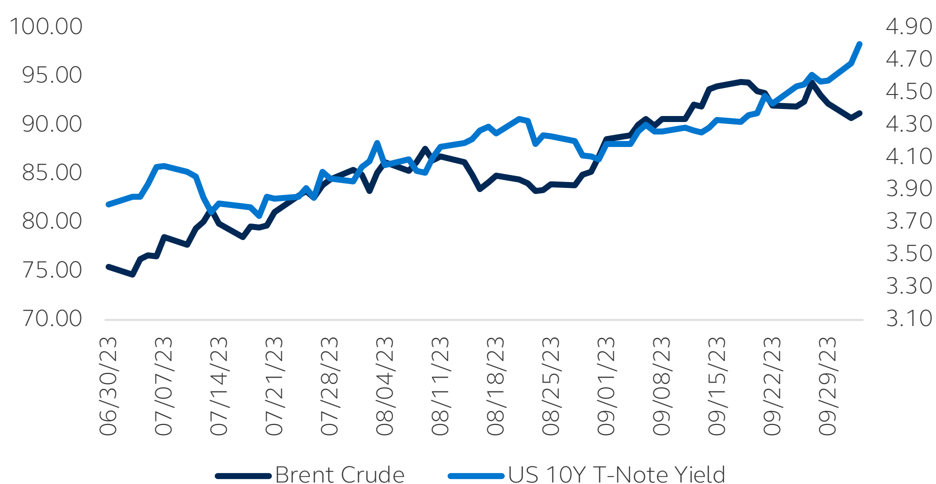
Equity market recap

THIRD QUARTER 2023

Notable themes

- **Higher for longer –** despite consensus expectations for Central Banks nearing peak tightening, 10-Year Treasury yields marched to their highest level in 15 years.
- **Cruel crude –** surprise production cuts and tight inventories fueled a ~30% rise in oil prices over the past three months, undermining future progress on inflation.
- **Mainstreet headwinds –** low-and-middle income consumers have largely depleted excess savings, just as the resumption of student debt repayments looms.

After a flurry of Central Bank decisions and resurging oil prices, investors became increasingly concerned that inflation could be more persistent, which will make it difficult for policymakers to reduce rates in the near-term. Equity markets succumbed to selling pressures during the latter stages of the third quarter amid the realization that policy rates and bond yields are likely to remain higher for longer than previously expected.



As of 3 October 2023. Source: FactSet

Over the quarter, Central Bank's policy decisions were fluid and data dependent. Following diverging policies, developed market central banks are mirroring each other in a stance that policy rates will need to remain high. As expected, the Federal Reserve (Fed) raised policy rates by 25 basis points, taking the benchmark rate up to 5.25%-5.5%, the highest level since 2001. This was followed by a pause in September though the latest dot plot left the door open for another rate hike this year and only two cuts next year—an upward revision to their previous dot plot and more hawkish than the market consensus.

Across the pond, the quarter closed with the European Central Bank (ECB) having raised its three key policy rates for the tenth consecutive time, opting again to raise rates by 25 basis points. Importantly, the Governing Council was apparently locked in heated debate and only reached their decision to hike by a majority vote, not by unanimity. The future policy path is still somewhat uncertain. Their statement noted that, “the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target,” suggesting that the ECB believes rates are now at an appropriately restrictive level and will just need to be maintained here until inflation pressures fade. Following 14 straight hikes, the Bank of England held its policy rate at 5.25% as a recent lower than expected inflation print skewed the members. Further increases remain possible as the region struggles with even higher inflation than continental Europe.

Bond yields surged higher in sync with the theme of higher for longer. The U.S. 10-Year Treasury Yield opened the quarter at 3.81% and trended steadily higher before closing at 4.57%, the highest levels since 2007. It wasn’t just a U.S. phenomenon as yields spiked globally. Both the European and Canadian 10-Year jumped in lockstep with the U.S., while in the U.K. and Europe, the moves were somewhat more muted. As a result, yield-oriented equities struggled, with utilities and real estate shares posting the largest declines within the sectoral league tables.

While inflation numbers have normalized from peak levels, they recently experienced an uptick and could face additional upward pressure due to the recent spike in oil prices. The August U.S. Consumer Price Index (CPI) report showed that headline inflation rose by 0.6% month-on-month, up from 0.2% in the prior month, but in line with consensus expectations, driving the annual figure up from 3.2% to 3.7%. Gasoline contributed to more than half of the gain in headline inflation and is likely to continue pushing up inflation over the coming months. Inflation remains persistent in Europe and the United Kingdom as food prices remain a significant problem.

It's undoubted that initiatives to rein in inflation have thus far worked but the rise in crude prices is at a potential crossroad of undermining future progress. As the quarter concluded, oil prices closed in on a one-year high amid surprise production cuts and tight inventories. Saudi Arabia and Russia agreed to extend their voluntary oil production cuts through the end of this year, removing 1.3 million barrels of crude out of the global market. Both West Texas Intermediate (WTI) and Brent prices closed above the $90/bbl., a 30% rise over the quarter. Energy stocks surged as a result, in sharp contrast to declines seen across nearly all other major sectors.

A looming U.S. government shutdown, which has been rectified for now, following a short-term deal (45-day funding) and ongoing United Auto Workers (UAW) strikes in the United States also weighed on investor sentiment as the quarter drew to a close.

Concerningly, lower- and middle-income consumers have seen their excess savings depleted amid the sharp rise in gas and food prices, elevated auto prices and sharply higher mortgage rates. Additional pressures loom as October will bring the expiration of the student loan moratorium.

In sum, hopes for a “soft landing” or shallow recession and adequate corporate earnings weren’t enough to dispel rate and inflation concerns for the period. The MSCI All Country World Index posted a 2.3% gross total loss for the quarter though year-to-date gains remain healthy at 10.5%. This was comparable to the S&P 500’s quarterly loss of 2.1% though returns through the first nine months

stand relatively higher at 13.1%. From a style perspective, value fared better than growth, globally and across the market cap spectrum, owing primarily to the outperformance of energy shares. Nonetheless, on a year-to-date basis, growth maintains a wide leadership margin, particularly among U.S. large caps. With the prior surge in "mega cap" stocks driven by the common theme of their involvement (or aspirations) in Artificial intelligence, the Russell 1000 Growth has outpaced its Value counterpart by more than 23% for 2023 thus far. MSCI Emerging Market Index performed in-line with its global peers moving lower by 2.5% for the quarter. MSCI EAFE reversed last quarter's gains of 3.2% led by weakness in the Netherlands and Germany..

The accompanying table summarizes regional and global sector aggregate performance on a USD basis, gross of cross-border tax withholding.

	3 months	YTD	12 months
MSCI World Index	**-2.28%**	**11.55%**	**21.43%**
North America	-1.92%	13.10%	19.47%
Europe	-3.61%	8.60%	31.64%
Pacific	-2.64%	5.77%	18.81%
MSCI Emerging Markets Index	**-2.48%**	**2.16%**	**12.49%**
China	-1.94%	-7.29%	5.24%
Asia Ex China	-3.48%	6.82%	16.47%
Latin America	-4.75%	12.89%	19.37%
EEMEA	-1.77%	-0.16%	5.62%
MSCI All Country World Index	**-2.30%**	**10.49%**	**20.43%**
Communication Services	1.19%	26.27%	27.85%
Consumer Discretionary	-3.71%	17.90%	15.48%
Consumer Staples	-5.23%	-2.28%	7.87%
Energy	11.78%	8.90%	28.41%
Financials	0.11%	3.31%	18.01%
Health Care	-1.57%	-1.83%	10.26%
Industrials	-4.24%	8.06%	26.38%
Materials	-2.80%	0.91%	18.18%
Real Estate	-5.93%	-5.67%	1.21%
Technology	-4.68%	28.76%	34.19%
Utilities	-7.41%	-8.65%	-0.11%

Sources: MSCI, Standard and Poor's in USD. As of 30 September 2023.

Looking ahead

Much of the equity market recovery from the October 2022 lows has been attributable to optimism about a "pivot" to more dovish monetary policy. Following the equity strength, expectations are for a more challenging backdrop in the near-term driven by:

- Central Banks to maintain rates higher for longer
- Elevated oil prices undermining progress on inflation
- Consumer pressures led by inflation and expiring student loan moratorium
- Geopolitics

Upward pressure on interest rates remains an overhang on broader risk sentiment with the focus being primarily on oil and Central Banks. Even as some investors are increasingly hopeful about the end of the current tightening cycle, there is risk that the full impact from tighter monetary policy has not yet been experienced. Officials have noted that rates may have to stay higher for longer than the market has expected.

This is not to say opportunities aren't in front of us but rather risks are on the rise. Supportive elements do remain in place, noted below, though have been tempered with the evolving backdrop and healthy gains year-to-date:

- Inflation normalizing
- Economic soft landing
- Central Banks signal rate cuts

Inflation numbers have normalized from peak highs but recently highlighted an uptick and with the potential to be stickier. In fact, August U.S. CPI posted its fastest monthly rise since June of 2022 led by the ongoing rise in oil prices, but the core inflation also disappointingly rose month over month. Inflation remains persistent in Europe as headline inflation in August outpaced expectations as food prices remain a significant problem, though did tick down from the previous month. Overall, inflation is trending favorably, but may be at a near-term impasse with crude oil showing a resurgence. It's evident pricing stability remains the initiative for Central Banks and at this point they are putting more weight higher inflation than the weakening growth environment.

Over the long-term, inflation is going to be pushed higher by near-shoring initiatives. The war in Ukraine and escalating geopolitics elsewhere has many countries reassessing their supply chains and trading partners. Investments are ratcheting up for more domesticated production, semis, food, and energy, while aligning with trusted countries. This will also drive long-term structural change opportunities.

After fluid and diverging policies, developed market central banks are mirroring each other in a stance that policy rates will need to remain high. The Federal Reserve (Fed) held rates steady at their September meeting, and, as evidenced by the latest dot plot, left the door open for another rate hike this year. There's no question the Fed is nearing the end of its year-and-a-half-long tightening cycle but don't expect a rate cut anytime soon.

In Europe, there were similar stories. Both the Bank of England (BoE) and Swiss National Bank held interest rate levels in September. Following 14 straight hikes, the BoE held its policy rate at 5.25% as a recent lower than expected inflation print skewed the members. Further increases remain on watch as the region juggles slowing growth, high inflation, and the delayed impact from previous hikes. The European Central Bank (ECB) hiked rates with a majority vote signaling they're keen on pricing stability as the growth environment weakens. The end of rate hikes is nearing a conclusion with a monthly data dependency outlook, but investors are focused on staying levels and for how long.

Despite cracks in the economic environment, the consumer has been resilient and the mainstay to contributing to adequate growth. However, there are now signs of a deteriorating consumer, particularly among the lower income households. Previous pandemic stimulus has been spent and inflation is now depleting excess savings. U.S. mortgage rates have surged to 7.3%, almost a 23-year high, and another headwind is upon us. The more than three-year long moratorium on federal student loans comes to an end and interest payments are set to resume in early October. There are

no doubt negative implications are set to hit growth over the next year and the Federal Reserve will need to tread carefully to avoid a potential "hard landing" scenario.

We believe we are in the midst of a generational change in global trade flows, as the West reduces its reliance on China and Russia. The U.S., Japan, and Europe should all experience expanding manufacturing bases. As the re-shoring trend accelerates and duplication in global supply chains increases, it will be a net benefit to global companies with the expertise in the capital equipment that will be needed to drive a manufacturing renaissance outside China. Japan has become an early winner in the deglobalization of supply chains with further upside coming from the increased attention surrounding Artificial Intelligence.

Artificial Intelligence is here to stay `but following a significant valuation re-rating for many known to be "intertwined" in the opportunity, earnings growth will remain the key over the long run. As the technology improves and additional features / functionalities are developed, generative A.I. will be embedded across wide swaths of the economy. The total addressable market remains very large domestically and internationally with sizable monetization potential. Generative AI is highly computer-intensive from both an algorithm training and content creation perspective. This level of data creation necessitates the need for significantly more GPUs relative to other compute / training workloads. The long-term structural change remains relevant, but key will be picking the winners from the losers as so many have significant aspirations.

Over the past decade, Japanese companies have made great strides in corporate governance and capital allocation. Former Prime Minister Shinzo Abe's push in 2012-13 to improve capital allocation in the corporate sector has had a lasting impact, driving more long-term, value-enhancing decisions by Japanese companies.

Continued progress on these fronts is primed to release shareholder value in the coming years. As companies focus on higher profitability and improve balance sheet efficiency, return on assets (ROA) will likely continue to improve given the tailwinds of reshoring and improving governance. Recent conversations with Japanese companies indicate a greater willingness to use strong balance sheets for modest share buybacks. In fact, they seem more attuned to the greater value accretion of counter-cyclical share buybacks (buying when shares are depressed) than U.S. companies—which tend to use traditional rolling buyback programs that don't emphasize buying for value. The early innings of this is coming to fruition in 2023 following years of engagement.

We're seeing progress, albeit slow, within Europe. Our improved sentiment is underpinned by three primary fundamental pillars:

- Structural renovation – We are finally seeing "green shoots" after many years of restructuring and tough policy actions.
- Innovation renaissance – Europe increasingly offers some interesting sources of innovation across sectors, providing valuable diversification.
- Global gateway, at a discount – Despite improvements, European companies continue to trade at historically low relative valuations compared to U.S. and global peers, providing an attractive and timely rebalancing opportunity.

Following a period of valuation improvement, earnings remain a key catalyst to further upside. Bottom-up stock selection will be key amidst uneven global economy recoveries and fluid Central Bank policies.

Risk Considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. Equity markets are subject to many factors, including economic conditions, government regulations, market sentiment, local and international political events, and environmental and technological issues that may impact return and volatility.

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MSCI Emerging Markets Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets. The index covers approximately 85% of the free float-adjusted market capitalization in each country. Information regarding the comparison to the MSCI Emerging Markets Index is available upon request.

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