PRINCIPAL

Investment Report Q2 2024

Artificial Intelligence fosters market concentration

At the beginning of the second quarter, financial markets were subject to higher volatility and divergent trends. While gold temporarily reached a new all-time high, global equities retreated as much as 5% during April. However, the stock market consolidation proved to be modest and only temporary.

In the second quarter, Gold increased by +4.3% and once again was the best performing asset class. At the same time, global equities rose by +2.4%, while global bonds lost -1.1% in value.

Seasonal effects

However, the performance of global equities should be viewed in a different light. In Europe, the Euro Stoxx 50 Index reached a new annual high on May 15th. Banking stocks have benefitted most from the European Central Bank's (ECB) 'higher-for-longer' interest rate policy. European stocks fell due to weak economic data and a negative reaction to the European elections. This year, the axiom 'sell in May and go away' roved to be accurate in Europe.

On a global level, however, the adage did not hold true. This is due to the fact, that the USA has a weighting of 63.5% in the global equity index MSCI All Country World. The US equity market, represented by the S&P 500 Index, recently reached a new all-time high. Within the S&P 500, the chip manufacturer Nvidia (+149.5% YTD) accounted for 68.2% of the S&P 500 performance in 2024. The S&P 500 Equal Weight Index highlights the increasing concentration of the US stock market.

Cause and effect

In particular, artificial intelligence is driving the investor frenzy. In addition, share buy-back programs on an unprecedented level are supporting current prices. In 2023, S&P 500 companies bought back USD 919 bn of their own shares (doubled the amount six years ago). In the first months of 2024, companies have already bought back USD 818 bn worth of shares. Recently, the index heavyweights Apple, Alphabet and Nvidia announced that they would be stepping up their buyback programs (Apple +110, Alphabet +70 and Nvidia +25 bn USD). A new all-time high is within reach.

The effects of elevated interest rates are becoming evident

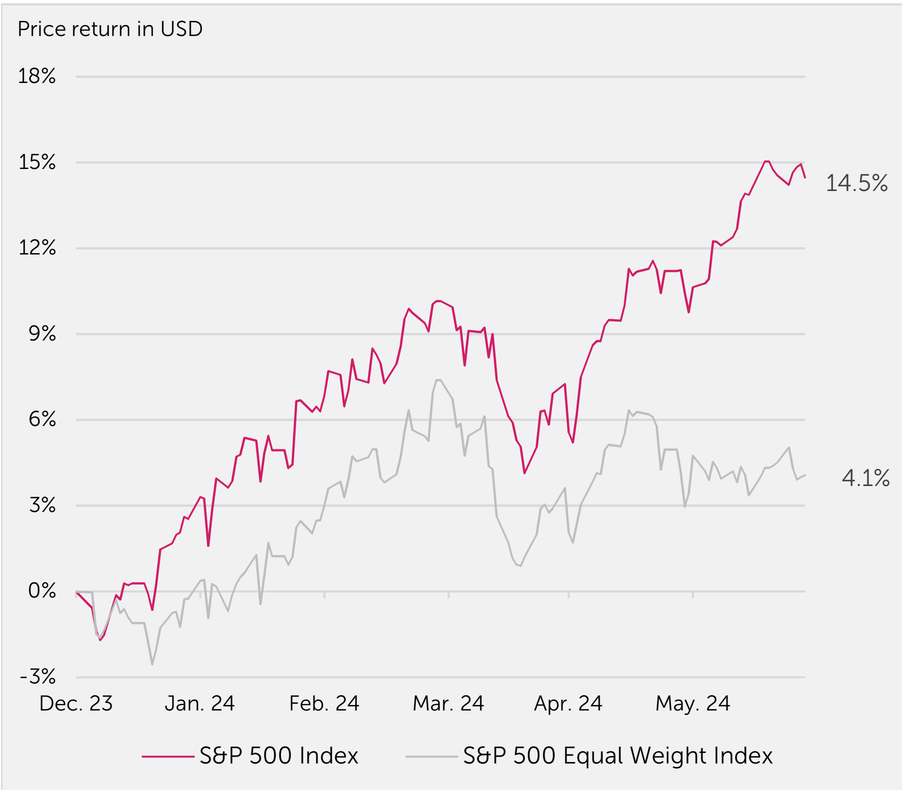
Due to higher interest rates, economic growth and inflation is coming back in many places.

In the US, Q1 annualized GDP growth came in at +1.3% only, having been revised down from +2.4%. At the same time, the unemployment rate rose to a two-year high of 4.0%. Compared to the previous year, 1.5 million part-time jobs were created, while 1.2 million full-time jobs disappeared.

In Europe, economic growth is fragile. In the first quarter, annualized growth in the Eurozone was merely at +0.3%. If economic growth falls, the money cycle slows down and inflation returns.

With wage and consumption growth coming back slowly, inflation in the USA and the Eurozone remains at an elevated level. As a result, central banks are acting prudently.

HIGH CONCENTRATION ON THE US STOCK MARKET



In the second quarter, the Federal Reserve (Fed) held the interest rate level unchanged. However, it revised its projections on June 11/12th and now forecasts only one interest rate cut, instead of three by the end of the year. This confirms our longer held expectations of a 'higher for longer' scenario at the beginning of the year. We stick to our base case of a 'soft landing' for the US economy.

In Europe, the ECB has fulfilled market expectations. On June 6th, it lowered its rates for the first time in almost five years. In view of the weak economic growth, interest rate derivatives are predicting at least one more cut this year and two further rate cuts of 25 basis points each in 2025.

Conclusion

Considering the resilience of the US economy and the upcoming presidential elections, we do not expect substantial market distortions in the coming weeks. However, a correction is possible at any point in time. For Europe, however, our optimism is limited. With regard to emerging markets, it is important to differentiate. India and Vietnam, for example, are very likely to benefit from the increasing geopolitical tensions between China, the USA and Europe.

A well-balanced asset allocation offers protection

Against the backdrop of the Fed's prolonged restrictive monetary policy and the further widening of US interest rate spreads against European and Swiss rates, we increased the USD exposure in the managed portfolios once again in May. Following the European elections and the announcement of snap elections in France, the Euro weakened against the US dollar and the Swiss franc due to increasing uncertainty.

In this environment, Euro denominated portfolios benefited the most from a relatively low Euro exposure and a significant allocation to US dollar, gold and Swiss franc.

Despite the strength of the US dollar and higher real-interest rates, gold continued its upward trend in the second quarter. The price trend continued due to the strategic purchases by central banks in India, China and Turkey. These counties are diversifying reserves away from the US dollar to gold and therefore have increased their gold reserves.

At Principal, we will maintain the tactical overweighting of gold in the managed portfolios due to the geopolitical risks and the expectation of falling real interest rates.

In the second quarter, only the strong overweighted Swiss equities and passive investments in US equities outperformed the global equity index MSCI AC World. On account of the extraordinarily low market breadth, active equity managers systematically underperformed.

With regard to the Emerging Markets, we replaced a highly diversified ETF with two actively managed Funds focusing on India and Vietnam. In doing so, we increased the allocation to equities of our managed portfolios slightly.

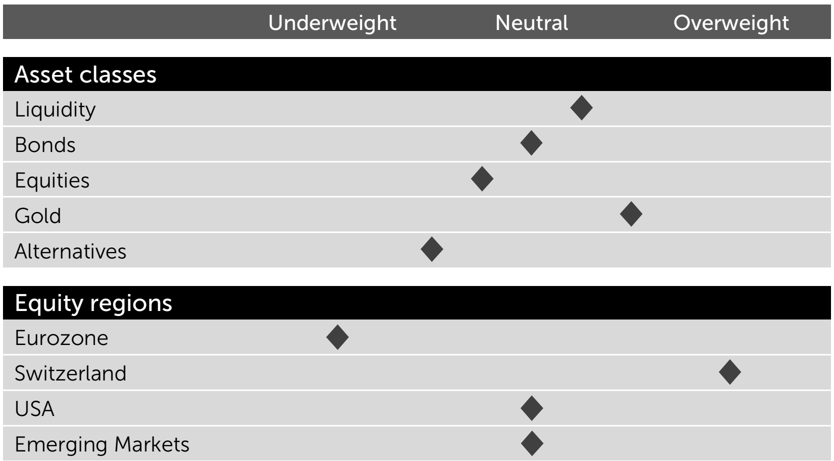
In the recent past, inflation continued to ease. If this trend continues, central banks will have the opportunity to cut interest rates. The expectation thereof could boost equity markets to new all-time highs and improve market breadth.

Once again, our bond investments outperformed the global bond index. We avoided investments in French government bonds due to growing account deficits, the high national debt and low yields. In addition to actively managed high-yield corporate bonds with short duration, we are currently focusing on liquid bond investments with medium- and long-term maturities. In the event of an economic slowdown that is more pronounced than we expect, or even a recession, these investments offer an effective hedge through the prospect of attractive price gains, as a result of interest rate cuts and inflation expectation revisions.

Conclusion

In the current market environment, we are maintaining our well-balanced asset allocation in the managed portfolios with selected portfolio stabilizers.

TACTICAL ASSET ALLOCATION (IN EUR)



Special topic: Cryptocurrencies

Cryptocurrencies are still a young asset class. They appeal with high returns, but also involve a high level of risk. Cryptocurrencies are becoming increasingly popular, especially among the Generation Z.

The world of cryptocurrencies

As the first cryptocurrency, Bitcoin was created on January 3rd, 2009. Until today its inventor remains anonymous. Throughout the first years, Bitcoin only received little attention. In June 2011, the cryptocurrency reached its first significant price of USD 10. With the discovery of its high-tech potential, combined with a certain amount of fantasy, its price multiplied in no time. Today, the price of one Bitcoin is about USD 62'000. This corresponds to an annualized return of 94.0%. At the same time, the cryptocurrency has seen a number of sharp sell offs. As a result, its price risk represented by the volatility equals 76.8% p.a. As the result of the potential comparably high-returns, a large number of new cryptocurrencies evolved in the middle of the last decade. These alternatives to Bitcoin are known by the abbreviation 'alt-coins'. The market for cryptocurrencies has grown rapidly over the last years. Today, the market capitalization of the five largest cryptocurrencies is USD 1'939 billion and represents 89.7% of the top-20-market capitalization. The combined market share of Bitcoin and Ether alone amounts to 77.1%.

THE 5 LARGEST CRYPTOCURRENCIES BY MARKET CAPITALIZATION

Currency	Ticker	Market capitalization in bn. USD	Market share
Bitcoin	BTC	1'249	57.7%
Ether	ETH	419	19.4%
Tether	USDT	113	5.2%
BNB	BNB	90	4.2%
Solana	SOL	68	3.2%

Source: Coingecko (as of June 28th, 2024)

The potential of a new technology

Cryptocurrencies have great potential. Transactions take place instantly, cannot be manipulated, are transparent and irreversible. They do not require any financial intermediaries such as banks, brokers or exchanges. As a result, payments using cryptocurrencies incur marginal fees.
In addition, various cryptocurrencies have some very useful features and are suitable for a wide range of applications. Bitcoin, for example, is primarily used as a payment system, while the Ethereum network is currently the leading blockchain for distributed computing. Solana stands out for its simplicity and high scalability and offers smart contract applications just as Ether.

The fair value of a coin

As with traditional investments, the price of a cryptocurrency is determined by supply and demand. The supply is defined ex ante. For example, the quantity of all bitcoins is mathematically limited to 21 million, of which 19.7 million have already been mined. Demand, on the other hand, is based on the technical properties and the associated fair value of the coin. Regarding the latter, literature offers various valuation models. The application to cryptocurrencies depends on the underlying protocol and the characteristics of the currency. If a cryptocurrency does not create any income (such as Bitcoin), the fair value can be determined using multivariate regression analysis.
If, on the other hand, there are cash flows (as with Ether and Solana), discounted cash flow models can be used.

The relevance of risk management

Since the invention of money as we know it today, the sovereignty over money supply has been the responsibility of the state or its central bank. This monopoly was lost with the creation of cryptocurrencies and is a thorn in the side of central banks. As a result, central banks are successively tightening their regulatory requirements, with nine countries even banning cryptocurrency trading. However, in view of the increasing acceptance among investors, the risk of a global ban is fading. Of greater importance are the considerable price fluctuations, which can lead to total loss in the case of small-capitalized cryptocurrencies.
In the case of established cryptocurrencies such as Bitcoin, Ether or Solana, we do not see a heightened risk of this.
With cryptocurrencies it is important to minimize the risk of hacker attacks. This can be done by choosing a reputable trading platform and by storing the currencies in a medium without internet connection, a so-called 'cold wallet'.

Cryptocurrencies in the portfolio context

The risk/return ratio of established cryptocurrencies has been attractive compared to traditional asset classes from a historical perspective. In addition, they are largely uncorrelated to traditional investments. In a portfolio, cryptocurrencies can therefore improve diversification and be a useful addition to gold. They can be implemented using exchange traded funds (ETFs) or specific product solutions.

Conclusion

Cryptocurrencies offer high potential returns, but involve high volatility and other specific risks. Due to these risks, they are not suitable for every investor. For this reason, cryptocurrencies are not considered in Principal's Strategic Asset Allocation. On demand, we will provide our clients with selected solutions for their individual portfolios.