

# The Put & The Pendulum

FACTORS AFFECTING THE GLOBAL ECONOMY IN 2016



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## HIGHLIGHTS

- **China and emerging markets:** China's economic engagement with important emerging markets has begun to falter
- **Surging commodity prices:** surging commodities prices have lost momentum due to the faltering investment boom in China and an increased supply of commodities
- **Non-U.S. labor-pricing power:** the pendulum is now swinging away from low-cost labor providers like China
- **The U.S. Credit super-cycle:** following the financial crisis, there is a movement away from U.S. fast-spending, credit-driven growth, and home-equity borrowing
- **Equities** likely have more upside than bonds in 2016. However, the best returns may be in real estate

**There is a famous pendulum** in Portland, Oregon named *Principia* (no relation to The Principal) that provides valuable insight as we look toward what 2016 holds for the global economy. *Principia* is a special type of pendulum, called a Foucault pendulum, which is named after the original device's inventor, French physicist Léon Foucault. Over the course of 18 hours, the arc of *Principia's* swinging globe makes its way completely around the circumference of its crown, as it proves the rotation of the Earth. It also shows the slight error people make when using the pendulum metaphor. Most will say, "The pendulum is swinging back..." implying a fluctuation between two predetermined states. However, after *Principia* swings away from its maximum angle, it will not wind up exactly where it was.

Newtonian physics and economics are vastly different in their predictive abilities. Indeed, physics has the advantage of being accurate; the forces that drive the pendulum are defined and predictable. Yet, the forces driving economic "pendulums" are indefinite, vastly harder to predict. Think of *Principia* as we examine the forces impacting the 2016 global economy. One can't know the end point to which those forces will take us, but we may know the direction!

## SWINGING AWAY FROM CHINA AND EMERGING MARKETS

The Uruguay round of world-free trade negotiations began in the 1980s and culminated with the creation of the World Trade Organization in January 1995. China and other emerging countries began to open their borders to the outside world. Free trade and open borders, combined with the collapse of the Soviet Union in 1989, created an immense labor supply shock. The global workforce doubled, from one and a half billion to three billion workers, as a vast number of underemployed and low-wage workers were able to join. For the first time, their products could be exported globally. Thus began an immense investment boom to absorb that huge number of new workers and created a one-time relocation of manufacturing from the West to China and other Southeast Asian nations.

China became the destination of choice for outsourced manufacturing. Its massive currency devaluation of the early 1990s created an export dynamo, the source of trillions of dollars of cheap goods for developed-country consumers. China's manufacturing boom also brought urbanization, enormous investment in infrastructure and demand for housing and property expansion. This all created skyrocketing economic growth not only in China, but also in other developing countries. China's voracious appetite for commodities propelled prices to record highs, providing commodity exporters with huge revenues and super-fast growth.

The economic surge created by free trade is waning, and our first economic pendulum is reversing. Growth in China is slowing for several reasons: the one-child policy has engendered a shrinking labor force; productivity growth has slowed; as wages have soared, the currency has strengthened and transportation costs have risen, manufacturing in other countries has become more competitive; high debt levels have made it hard to increase growth through more borrowing; and years of monumental investment has brought colossal overcapacity.

→ The economic surge created by free trade is waning and our first economic pendulum is reversing. Growth in China is slowing for several reasons.

**Other developing countries** that were pulled along with the boom are also faltering. Profits and cash flow are deteriorating; debt is too high; producer prices are falling; commodity prices have collapsed; industries are plagued with over-supply, excess capacity, and heavy inventories. The export-driven growth model that relied on competitive labor costs is fading. Global companies are now re-examining where their production should take place. In some cases, the United States is becoming the choice destination as costs become competitive once again, a phenomenon dubbed "reshoring." Unit labor costs today for U.S. manufacturing are actually flat to slightly lower than they were in 1980.

## SWINGING AWAY FROM SURGING COMMODITY PRICES

China's insatiable appetite for commodities drove the economic surge in emerging markets and is the source of our second economic pendulum. The gigantic investment boom in China generated a commodity super-cycle — an across-the-board, decade-long gale of surging commodity prices. Now, as China's growth slows and its investment rush wanes, this pendulum is swinging away from the era of ultra-high prices.

Soaring prices for metals, minerals, energy, and agricultural products drove commodity producers to invest more and more capital to expand capacity and increase supply to meet that burgeoning demand. But, just as the new supply began to come to market, demand growth faltered and prices collapsed across the commodity landscape.

The 60% to 70% plummet in most commodity prices from their peaks of a few years ago makes the end of the commodity super-cycle unambiguous and mostly old news. What is new is the view that this is likely a secular trend and that faltering demand and excess supply will last for some time...possibly even years. Producers will keep producing as long as prices are above their variable cost of production, a recipe for persistent oversupply in excess of demand. A more normal commodity cycle will eventually assert itself; one driven by cyclical changes in supply and demand. Commodities will likely not see new inflation-adjusted record high prices any time soon, probably not even in the next decade or longer.

The implications are widespread. Commodity-producing nations will continue to feel the pinch from dwindling revenues. Saudi Arabia reportedly withdrew US\$70 billion from its asset managers to plug holes in social spending. Norway had to tap its oil fund to fill its spending requirements. Brazil's economy is in tatters for several reasons, but the plunge in oil prices is not the least of them. Canada may not avoid a technical recession as oil supplies surged and prices slumped. Growth has slowed significantly in Australia as the mining boom unwinds. Russia is in the midst of a

debilitating recession. In the United States, thousands of workers have been laid off in the shale oil areas of North Dakota and Texas.

While the collapse in oil prices is bad for those in the oil business, it's an economic benefit to the rest. Chief among the latter are China, India, and the Eurozone, all of which are large oil importers. Another example is Chile, who lost sizable export revenue as copper prices collapsed, but with large oil imports, its terms of trade remained about flat. U.S. citizens who own large SUVs have about 60% less in gasoline expenses each time they fill the tank, leaving an extra US\$50 or so in their bank account — multiply that by tens of millions of drivers. Manufacturers also enjoy lower input prices, which boosts profits. Plunging commodity prices led to gains in technology and productivity as producers tried to cut costs. High prices brought behavioral shifts and more efficient and frugal commodity use. Governments can reduce gasoline subsidies with less fear of being turned out of office. There has never been a U.S. recession associated with falling oil prices; it's always been the opposite since 1960.

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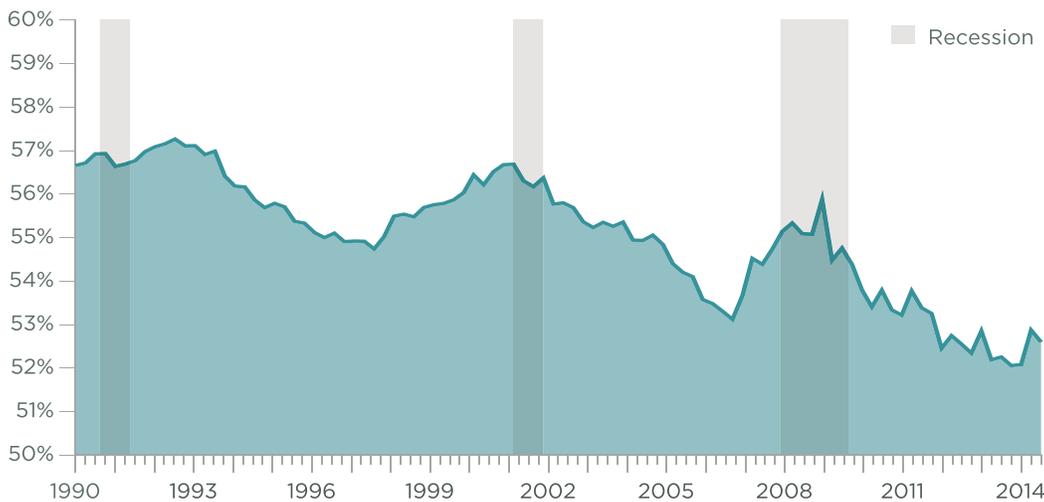
## SWINGING AWAY FROM NON-U.S. LABOR PRICING POWER

Another pendulum that's reversing involves the forces that govern global labor costs. The advantage is moving away from formerly low-cost labor providers like China, where fast-rising wages have eroded their competitiveness. As global companies invested in China to absorb that new supply of cheap workers, U.S. manufacturing lost six million jobs. This loss and the competition created by hundreds of millions of low-cost workers put significant pressure on U.S. middle-class incomes. It happened in other countries as well. In past decades, Mexican wages were much higher than in China, so manufacturing areas in Mexico began to empty out too. In the United States, the employee compensation share of gross domestic income has fallen at an accelerating rate since the early 1990s after being somewhat flat for 20 years (Exhibit 1). It has been languishing near 50-year lows this decade. But, wages in China have grown at 10% or more for well over a decade. Further, many rural workers left their farms and families to work in cities for higher paying manufacturing and construction jobs. It's the so-called Lewis Turning Point and the competition with developed-country workers

is diminishing. So, it's likely that the recent upturn in the employee share of total U.S. income marks the reversal of its long downturn, where developed country households regain some pricing power for wages.

→ Another pendulum that's reversing involves the forces that govern global labor costs. The advantage is moving away from formerly low-cost labor providers like China, where fast-rising wages have eroded their competitiveness.

**Exhibit 1: Employee Compensation Share of GDI** In the United States, the employee compensation share of gross domestic income has fallen at an accelerating rate since the early 1990s.



Source: Bureau of Economic Analysis, Principal Global Investors

As noted, cheap commodity prices raise household real income, the quantity of goods they can buy at a given price. Combined with weakness in profits in emerging markets, this represents a fundamental shift in the distribution of global income, with an increasing share going to consumers and a smaller portion left for producers.

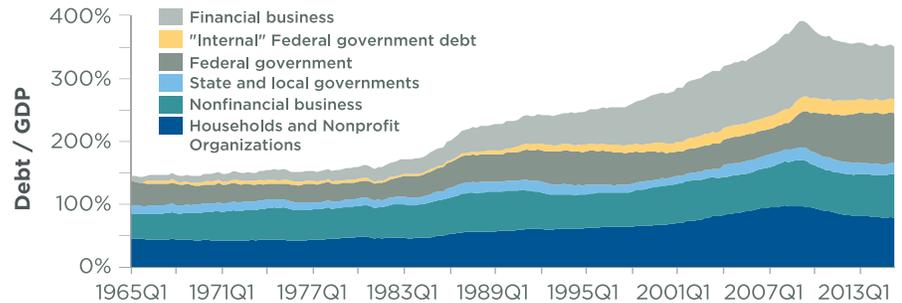
## SWINGING AWAY FROM THE U.S. CREDIT SUPER-CYCLE

For 60 years, U.S. debt has been increasing relative to GDP. The private sector came out of the Great Depression with an egregious distaste for credit. Excess debt had caused so much trauma, bankruptcy and hardship that the public wanted nothing to do with debt. Over time and generations, that loathing withered away and private as well as government debt rose much faster than GDP after 1980 (Exhibit 2). An extra incentive to increase borrowing was the three-plus decade fall in bond yields after 1981. That inexorable rise in debt gave the Federal Reserve (Fed) its power to mitigate the damage from recessions. When a downturn began, the Fed would cut interest rates and cheaper loans would induce the private sector to borrow more and increase spending. Consumption would be pulled from the future to the current time and that extra spending would boost growth and end the recession... viola, recovery.

This time that fast-spending, credit-driven growth that kept U.S. purchasing rising smartly, even while wages stagnated is absent. The severe financial crisis of 2008 had a similar cautionary effect on households as the Great Depression. Consumers deleveraged, paid down debt, became more frugal, spent within their income, raised savings, and refused to borrow. Businesses were equally chastened and raised cash, slashed payrolls, sliced investment, curtailed borrowing, and stayed prudent. That extra restraint and caution has kept the U.S. expansion in slow gear. We call it PCRD, Post Crisis Relapse Disorder; it's where one wakes up every morning thinking they're still in a recession. People are acting like we are still in a recession, even though there has not been a mention of a double-dip recession in over two years.

### Exhibit 2: Private & Government Debt to GDP

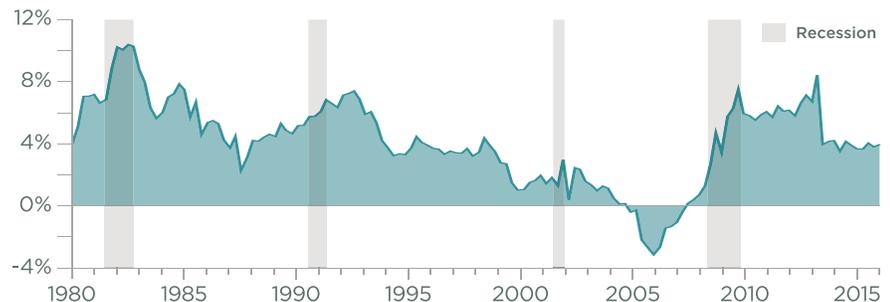
After 1980, private and government debt rose much faster than GDP.



Source: Federal Reserve, Principal Global Investors

### Exhibit 3: Household savings as a percent of disposable personal income

U.S. consumers have dialed back spending and increased their savings rates following the 2008 financial crisis.



Source: Bureau of Economic Analysis, Principal Global Investors

The 60-year U.S. debt super-cycle is over at least for households. Consumers reached what they thought were their maximum debt levels in 2008 and stayed frugal. It's not that the credit pendulum is going to crush debt back to the levels of post-World War II. It's just that leveraging and spending as a way of life is over for consumers. The private sector will likely not ramp up borrowing excessively anytime soon. We expect thrift, prudence, and increased desire for savings to continue; consumer spending growth to stay within the bounds of income; and the pace of economic expansion to stay below the fast lane. The split between the free-spending ways of the late 1990s and 2000s versus the high savings of today is readily apparent (Exhibit 3). We expect the latter to continue.

The Fed's primary tool of monetary policy is the federal funds rate (fed funds). Over the years, the Fed learned to utilize that lever to successfully ameliorate the ravages of recessions. In the 1980s, Fed Chairman Alan Greenspan used the instrument so effectively that the endeavor was affectionately known as the "Greenspan put." The problem now, as the debt super-cycle has faded, is that inducing people to borrow to mitigate recessions has lost its effectiveness. In fact, debt in general has

lost its power to stimulate. Table 1 shows how much an extra dollar of debt raised GDP in each expansion since 1960, measured from the prior business cycle peak to the current top. The first row uses total credit market debt; the second uses private non-financial debt. Both show the same effect: the return in dollars of GDP from an extra dollar of total debt plunged from \$0.68 in the 1960s to a measly \$0.19 in the 2000s...not much marginal impact.

**Table 1:** This table illustrates how much an extra dollar of debt raised GDP in each expansion since 1960, measured from the prior business cycle peak to the current top. Both credit market debt and non-financial debt show the extra dollar of total debt plunging with minimal marginal impact.

Expansion Peak to Peak	1960 thru 1969	1969 thru 1973	1973 thru 1980	1980 thru 1990	1990 thru 2001	2001 thru 2007	2007 thru 2015
\$ GDP per All Debt <sup>1</sup>	0.68	0.64	0.59	0.35	0.32	0.19	0.33
\$ GDP per Private NF <sup>2</sup>	0.98	0.97	0.97	0.70	0.67	0.41	1.58

Source: Federal Reserve, Bureau of Economic Analysis, Principal Global Investors

<sup>1</sup>Credit market debt <sup>2</sup>Non-financial debt

With no ability to help the economy through cuts to the fed funds rate, the Fed looked for another tool and found quantitative easing (QE) or large purchases of long-term bonds. The idea was that, with short rates near zero, central banks could push long-term rates lower by buying large quantities of long-term bonds. The principle was the same: cut interest rates to induce economic participants to borrow to spend or invest; the QE difference was to use long rates as the lure rather than short rates.

Extraordinary tools brought unanticipated outcomes. Rather than stimulating the economy, those ultra-low long rates prompted a desperate and global search for yield. Investors found better yields in developing countries, and hundreds of billions of dollars flowed into emerging market debt funds and local corporate bonds. That easily available credit helped push

emerging market debt to levels that are now causing repayment problems as cash flows and profits wither. Some of the "search for yield" money also went into the high-yield debt of U.S. shale oil producers, which got downgraded as oil prices plummeted. Some (perhaps many) of those higher-yielding credit issues that were in such exorbitant demand have become questionable; ratings have slumped and prices have collapsed.

Many economists and pundits worried that QE would end in horrendous inflation. But, the real lesson learned seems to be that easy money actually brings deflation, rather than inflation. Radically low interest rates make many more low-return projects affordable. So, more production facilities get built, supply turns to excess and prices crash: oops, deflation, not inflation.

**Global growth rebalances; no hard landing:** Changes in global competitiveness suggest world growth is rebalancing: for example, what was slow is picking up, what was fast loses steam, and what was expensive gets cheaper. Developed economies have become more competitive and are clearly improving. The rule is first in, first out.

## United States



**The United States** went through its financial crises in 2008 and did what had to be done. Businesses and households cut back and became prudent, banks recapitalized and recovery continues. We expect the U.S. economy to expand 2.5% in 2016, driven by robust consumer spending, wages that are accelerating, exceptional job growth and rising real incomes. The U.S. private sector has grown at a 3% pace since the recession ended and the headwinds that kept overall growth to a measly 2.2% are fading. Capital spending is likely past its nadir. Government purchases are no longer shrinking. Winter weather will be better than last year, given the strong El Niño effect. The Fed will stay accommodative, with gradual rate hikes. The caution inherited from the severe crisis may keep growth a little sluggish, but should fade gradually. Many worry about weak capital spending; business investment may also re-equalize to some extent as it decelerates in the developing world, while it picks up in developed countries as domestic demand strengthens.

## Greater Europe and Japan



**Greater Europe** also went through its financial crisis some years prior and recovery should continue. We expect Eurozone growth at a 1.5% to 2% pace next year. The weak euro and cheap energy will persist and boost growth. European Central Bank (ECB) policy will remain very easy and interest rates low. Household demand has been and will stay resilient. Lending standards have eased and loan demand is picking up.

**Japanese** growth is progressing too. Third-quarter GDP was revised higher on the back of strong capital spending and decent household demand. Its labor market is extremely tight and wages are rising. Corporate profits are percolating. The plunge in the yen is underwriting some of that growth.

## China



**In China** and other developing countries, growth has faltered and will slow further when the excesses from the boom years begin to be excised. That's not happening yet but, there are still substantial headwinds facing the developing world: deflating prices, falling profits, excess supply, over capacity. However, if growth in the United States, greater Europe, and Japan continues to improve, emerging countries should avoid a hard landing in 2016. Movements in exchange rates are redistributing growth around the world. The strong U.S. dollar is pushing U.S. economic vigor outward and weak emerging currencies will provide a boost locally. Chinese economic data is no longer deteriorating. While the Fed will raise rates further in 2016, the pace will be slow with the fed funds rate ending the year at 0.75% or 1%. That plodding tempo should not be too stout a gale for the emerging world.

## A RECOVERY YEAR

Consensus trades strongly favor continued commodity price weakness and an ever-stronger dollar. Those trends are likely not far from their zenith. The December plunge in oil prices is likely a final capitulation and catch-up to the price action in metals. Copper prices have stabilized recently and the CRB Raw Industrial Index is no longer plunging as it had steadily since May 2014. The JPMorgan Global Manufacturing PMI has stabilized recently and quit decelerating. We see the U.S. dollar mostly just maintaining its strength, which should allow commodity prices to stabilize around recent lows. The dollar may rise a bit more after the fed funds rate hike, but the bulk of its advance is likely over. Yes, the Fed is hiking while other central banks stay easy, but that is old news and markets surely reflect that. Even after the lows are in, though, commodity prices have little room to rebound much until demand growth begins to catch up to that of supply, which may still be some way off.

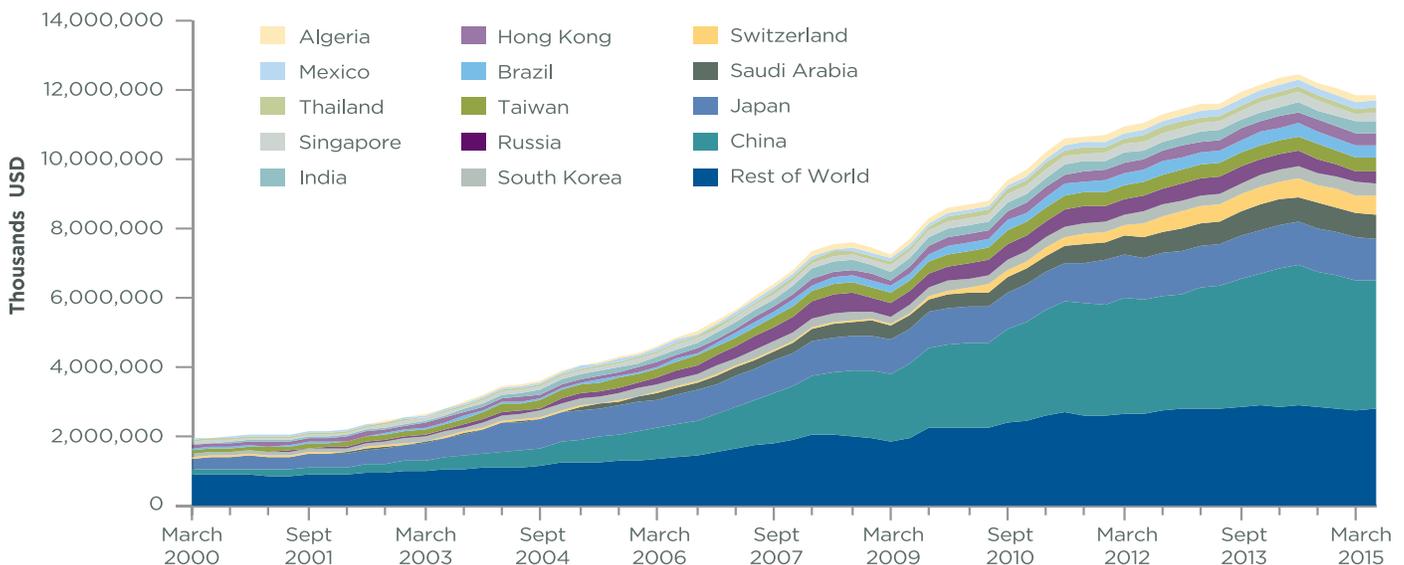
## FINANCIAL RISK IS IN EMERGING MARKETS

The problem for the developing world is that the imbalances built during the boom years are only getting bigger. Debt is still rising, companies are still producing, supply and capacity are still increasing. There has been little consolidation and no deleveraging. If conditions worsen, there is significant risk of a hard landing or crisis. A spike in defaults in China or other developing countries would create a rush for the exits in local-debt funds. Liquidity would vanish and bond prices would get crushed. Outflows are the biggest risk and would put even more pressure on currencies, making dollar-denominated debt payments even harder. Official reserves, which soared sixfold from 2000 to 2014 to a record \$12 trillion, are already shrinking (Exhibit 4). If countries with managed currencies try to use reserves to protect their exchange rates, the local money supply would shrink and tighten financial conditions even further.

The potential for further trauma in emerging market, though, seems more of a risk for later in 2017 than this year, if growth indeed improves and commodity prices hit bottom. If the Fed maintains its tightening course, the U.S. economy may find headwinds of its own in late 2017, limiting its ability to help emerging countries muddle through and grow out of their troubles. The risk is that these headwinds turn into a financial storm somewhat earlier, even in 2016, impacting developed economies sooner than anticipated.

### Exhibit 4: Official Reserve Assets

Official reserves that climbed to a record USD12 trillion from 2000 to 2014, and are beginning to shrink.



Source: International Monetary Fund, Principal Global Investors

# CONCLUSION

The price surge of most risk assets after years of zero interest rates suggests that future returns will be hard to find. The long bull market in developed, country bonds is surely over. Evidence is the inability of yields on 10-year U.S. Treasuries to breach the 2% level to any degree since April even as fears of global recession spiked in August. Similarly, yields on 10-year German Bunds refused to collapse again below 0.4% even when expectations for extreme ECB action were at their recent peak; and that's well above their record low of 0.07% last April. The pressure on U.S. interest rates is mixed: ample global savings, low competitive yields, low inflation, little desire to borrow or opportunity to invest push rates lower. But, the savings glut is shrinking, global growth should improve, the Fed is hiking and inflation is not dead, just resting. Net, net, we'd say modestly higher.

Credit spreads have widened dramatically since last April from fear of default by companies sensitive to commodity prices. Since no U.S. recession has ever been associated with a plunge in oil prices, only the reverse, default risk may stay contained, suggesting that those higher yields in credit may be somewhat enticing, at least for a trade. We'd only date them for a little while, though, and not get married.

Equities likely have more upside than bonds in 2016. The potential, though, may be limited to earnings gains as price-to-earnings (P/E) multiples will not expand. P/Es are not grossly extreme, just well above long-term averages. U.S. earnings growth at mid-single digits plus a couple of points for dividends would yield total return in the mid-to upper-single digits for a large-cap index. Eurozone and Japanese equities may be attractive because there is greater potential for upside earnings and growth surprises. However, the U.S. investment cycle is likely in its later stages and the upside may be limited by contagion from the problems that have not yet been resolved in emerging markets.

The best returns may be in real estate. While cap rates have fallen, they are still wide versus U.S. Treasury bonds. Building prices are on the way up, as are rents, two of the three drivers of real estate returns. Interest rates will rise some, but prices and rents should keep returns decent. U.S. REITs had been overpriced and just under flat for the year. Global REITs may have some opportunity.

While 2015 has witnessed a rebalancing of growth, we can expect that in 2016 developed economies will continue to improve and become more competitive. In conclusion, while the forces driving economic "pendulums" are indefinite and harder to predict, like *Principia* we can't know the end point to which global markets and economies will ultimately take us, but we may know the direction.

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