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Economic Insights

Commentary by Bob Baur, Robin Anderson, and the Economic Committee

Topic summaries:

- **What happens after growth peaks?**
  A bit of deceleration. When things are so good they can't get any better, they usually don't. Still, the robust momentum should carry well into 2019.

- **An investment type heads the Fed:**
  Fed watchers may have to get used to new Fed Chair Powell's plain, clear, and unhedged language. Inflation is edging higher and interest rates may rise a bit more before plateauing for a few months.

- **Asset allocation: February had no place to hide:**
  The wickedly fast and deep February downdraft led to an ugly month for most investors. A retracement back to those early-month lows may be a good place from which to enjoy gains from a potential late-inning rally as the world economy remains robust.

For the month of February 2018

What happens after growth peaks?

A bit of deceleration. A synchronized pickup in global growth has been happening for some time. It started in early 2016 after the commodity rout ended; then, gathered steam in 2017. Japan, the Eurozone, and the United States grew above trend; Chinese growth decelerated but the slowdown was smooth. Commodity prices and global trade perked up nicely. Confidence and other survey measures soared, hitting record high after record high in some cases. Economic data kept surprising on the upside, especially in Europe. Investors and businesses finally realized the post-financial crisis growth slump was over.

But, when things are so good they can't get any better, they usually don't. So, world growth may have reached its best pace and be starting to lose just a bit of momentum. Commodity prices are likely very near a peak. J.P. Morgan's global summary of business surveys seems to be past its top. Other country confidence surveys may also have crested. Investors have gotten used to stronger growth, so, economic surprises, i.e., when data beats expectations, are harder to find.

The Eurozone:

Citigroup's Economic Surprise Index turned negative in late February, for the first time since 2016, and recent survey data have broadly softened. The Eurozone composite business survey fell over a point to 57.5, and country-specific surveys generally fell too. Germany's Ifo Index of business confidence, Eurozone economic sentiment, and ZEW investor surveys are all off their highs. That doesn't imply a growth slowdown, just that reaching record high after record high is not sustainable.

There are plenty of reasons for Eurozone optimism: survey levels are still consistent with robust growth, labor markets are healing, and the unemployment rate, at 8.6%, is the lowest in years. Germany's labor market in some ways is the best it's ever been. According to a European Commission survey, Germany had its largest shortage of industrial labor ever. All this is supportive of domestic demand. And robust global growth should bolster exports, even with a stronger currency as a headwind. We expect a 2% to 2.5% pace of growth this year, with a bit of upside risk.

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When things are so good they can't get any better, they usually don't.

Bob Baur • Chief Global Economist, Principal Global Investors

Japan:

Growth in GDP slowed in the fourth quarter to a miniscule 0.5% quarter-over-quarter annualized pace, from the above 2% pace of the prior two quarters. No surprise, as trend output growth for Japan is probably between 0.5% and 1%. In fact, according to Cornerstone Macro's calculations of data from the Organization of Economic Cooperation and Development, Japan has been growing above potential for the last six years. At some point, growth had to revert. Industrial production plunged in January, down more than 6% over the prior month. While some of the decline is noise associated with the Chinese New Year, it's still a huge drop. Japan's manufacturing company survey fell a bit to a still strong 54.1. The Reuters Tankan poll of large company confidence dropped as well. The unemployment rate is an incredibly low 2.4%, and we expect 1% to 1.5% GDP growth for 2018.

China:

The growth deceleration is probably starkest in China. The official survey of manufacturing businesses fell a point in February to 50.3, just above a contraction level. Some of the decline may be due to problems of New Year data, but the magnitude of drop is sizeable. The Caixin China manufacturing purchasing managers index" did rise slightly to 51.6; but, the hard indicators of railway freight and oil, steel, and copper production were slowing through the end of 2017. Credit growth continues to wane; the broadest measure of credit fell 17.2% from January 2017. The government is achieving its goal of less unconventional lending and credit growth is slowing to a more sustainable pace.

The United States:

U.S. growth prospects may have room to run. All major U.S. consumer confidence indices are at or near record highs. The Conference Board's measure of how consumers view the job market reached the best level since 2001. The manufacturing survey from the Institute of Supply Management leapt to the strongest level since May 2004. Initial claims for jobless compensation plunged to the lowest since 1969! However, some key statistics did slow in January: retail sales, industrial production, new- and existing-home sales, and durable goods orders were all lower. Fourth-quarter GDP growth was revised down slightly, to 2.5%, mostly from a marginally worse drag from inventory gains. Consumer spending growth remained vigorous at 3.8%.

The tremendous strength in the U.S. labor market should keep consumer spending healthy. Wage gains are picking up, which will provide further support. Investment spending rebounded and should continue strong, induced by tax incentives. Easier lending standards for commercial and industrial loans is a tailwind to growth. And there is plenty of room for capital spending to run; U.S. capital stock is old, and in some cases very old; there is plenty of pent up demand. So, the United States not only has strong underlying domestic demand, but, fiscal stimulus from the tax package and a new budget should provide extra support, especially for capital spending.

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Conclude:

So, what happens after peak growth? A bit of deceleration because the pace of world growth may have peaked. Strong surveys have likely climaxed in Europe. Growth in Japan is pushing toward trend. China's long slowdown has begun. Some U.S. data slowed in January even if it's partly or mostly weather related. Still, 2018 should be a good year for the global economy with that bit of deceleration and a peak in commodity prices. The strong momentum should carry over well into 2019. Specific U.S. forecasts are in the table at the end of the report.

An investment type heads the Fed

Fed watchers may have to learn a new language with Jay Powell at the Federal Reserve (Fed). His straight, clear, and unhedged talk in his first Congressional Committee appearance seemed to unsettle investors who had become used to economics PhDs who note "on one hand" before describing "on the other hand." He plainly stated that his "personal outlook" for the U.S. economy had strengthened since the Fed's December meeting: nothing new there since it's true. However, Powell's clear language suggested that he was setting the stage for the Fed to hike four times in 2018. Markets sank on that reading. More likely is that Powell's business background was simply leading him to state the obvious: that U.S. growth prospects had indeed improved. Nothing else in his words inferred that the Fed would depart from its path of gradual rate hikes.

Inflation watch:

Waiting for inflation to reach the Fed's target has been like "Waiting for Godot," the play where two men wait for another named Godot who never arrives. The Fed has been worried that inflation would stay too low or touch its target and fall again. That suggests Fed policy will stay gradual even if inflation mildly exceeds its target for a while.

We agree. Inflation will surely hit and perhaps surpass the Fed's target this year, given the robust economic expansion. But, with commodity prices and world growth momentum peaking this quarter, it's unlikely a surprise spike in inflation would force the Fed to be more aggressive.

For some time, the consensus has believed that inflation and interest rates would stay "lower for longer." That consensus has reversed as 10-year U.S. Treasury yields surged from about 2% in September, to a recent high of 2.95%. Vigorous global growth and inflation quietly edging higher both helped bring that change of heart. Recent U.S. rate history is shown in the table below.

Interest Rates

	12/31/2015	12/31/2016	12/29/2017	02/21/2018 (High)*	09/07/2017 (Low)*	02/28/2018 Current
2 year	1.05%	1.19%	1.88%	2.27%	1.27%	2.25%
10 year	2.27%	2.44%	2.41%	2.95%	2.04%	2.86%
10-2 spread	1.22%	1.25%	0.53%	0.68%	0.77%	0.61%
30 year	3.02%	3.07%	2.74%	3.22%	2.66%	3.12%

*Twelve month high and low, based on the 10-year Treasury bond over the prior 12 months
Source: Bloomberg

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Yields near a plateau?

Could be. The 1% rise in five months caused considerable indigestion in world stock markets. The wonder is why interest rates had not risen sooner than last year's fourth quarter. It's been clear to us that robust growth coupled with stock markets screaming higher meant that yields on long-term bonds had to rise. Nominal U.S. growth of 4% to 5% is just not compatible with 10-year U.S. Treasury bond yields of only 2% to 2.5%.

How far up rates move depends on how aggressive the Fed will be in their rate hikes this year and next. The market consensus is ramping up rate hike expectations for the next two years. Some Fed watchers predict four quarter-point rate hikes this year and next. That would put the fed funds rate in the 3.5% range. Fed funds that high would likely become a big drag on U.S. growth, unless U.S. nominal growth stayed in the 4% to 5% range. If it did, long-term Treasury yields would likely approach that same level.

In the short-term, a 3%+ yield on 10-year U.S. Treasury bonds will likely bring a plateau in rates and a calmer Treasury market. The most recent high was 3.05% on January 2, 2014 and markets feel like they want to at least match that peak before stabilizing. The current and recent gyrations in stock markets will also keep yields from surging very far.

Further, the sharp rise in long-term yields, market volatility, widening corporate spreads to Treasury bond yields, and a stable U.S. dollar have already tightened financial conditions significantly, doing some of the Fed's heavy lifting. If those trends persist, it wouldn't be unthinkable for the Fed to be more rather than less gradual with its rate hikes. Our yield expectations are in Exhibit II. The estimates for year-end 2019 though, are clearly only guesses and depend entirely on economic growth and the stock market continuing its upward momentum through next year.

Interest Rates	Year-end 2017	Year-end 2018
Federal Funds	2.13%	2.63%
2-Year UST Yield	2.5%-2.75%	2.75%-3.0%
10-Year UST Yield	3.0%-3.25%	3.25%-3.5%
2-10 Year Spread	0.5%	0.25%-0.5%

Asset allocation: February had no place to hide

What an ugly month. Very few investors got through February with any gains. Only those who had cleverly parked their investments in cash by late January had a positive return. Only five of the 46 world equity indices we track were positive for the month, and one of those was just barely flat. There were no U.S. or global MSCI sectors with gains. The S&P 500 Index was still up 3.0% for the year-to-date with dividends, even after losing 2.6% for the month. The MSCI Emerging Market Index still basked in its two-month glory of a 4.6% price return, but only after seeing 3.4% evaporate in February.

Bonds offered no diversification or any safe haven since only one of the 21 bond indices we follow had a gain; that was an index of short-term U.S. Treasurys and it was only fractionally better than flat. Real estate investment trusts (REITs) had some of the worst returns, hit by surging long-term interest rates. MSCI indices of U.S. and global REITs were off in price 7.9% and 6.7% for the month, and 11.9% and 7.9% year-to-date, all respectively.

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Looking ahead:

On January 26, we suggested being cautious and taking a few more chips off the portfolio table, beyond the chips we had recommended taking off a few months before. We thought there would be better opportunities ahead; improved values have started to appear. The huge downdraft in early February, a peak to trough plunge of 12.2% on the S&P 500 Index in 10 trading days, was dreadfully, wickedly fast and far. As noted two weeks ago, it was triggered by faster-than-expected wage growth in January, accentuated by volatility sellers trying to limit their losses; but, the fundamentals of rising interest rates implied the correction was waiting to happen.

It may be time for stock markets to fully adjust to higher long-term yields, so this correction might not be over for a month or two. The downdraft is being exacerbated by the March 1 announcement of tariffs by the Trump administration. There could be another wave of selling to come if long-term Treasury yields breach 3%, surpassing the early 2014 high; that could take the S&P 500 Index back to its earlier February low or a bit beyond.

If a further correction happens, it might be a good time to put those chips back to work if indeed they were taken off the table earlier. The reason is that world economic momentum is still quite strong even if it climaxed in the Eurozone this quarter and earlier in China and Japan. The extra capital spending induced by the tax package will keep U.S. growth at the top of its range likely for several quarters yet. The Fed will still be accommodative even if the committee raises rates two or three times in 2018. Profit growth will be excellent and long-term interest rates should stabilize before too long. All this could generate a nice, late-inning rally in the long investment cycle that began in the United States in March 2009.

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Baseline Economic Forecasts for 2018-2019, by Quarter

Baseline Forecasts

A. Growth in Real GDP - Qtr-Qtr (% Change, Annualized):

	1st QUARTER 18 Forecast		2nd QUARTER 18 Forecast		3rd QUARTER 18 Forecast		4th QUARTER 18 Forecast		2016 ACTUAL		2017 ACTUAL	
Real GDP	**17,416.9**	**3.4%**	**17,560.1**	**3.3%**	**17,701.4**	**3.3%**	**17,842.4**	**3.2%**	**16,716.2**	**1.5%**	**17,092.5**	**2.3%**
Personal Consumption Expenditures	**12,127.2**	**3.3%**	**12,218.0**	**3.0%**	**12,305.2**	**2.9%**	**12,393.1**	**2.9%**	**11,572.1**	**2.7%**	**11,888.9**	**2.7%**
Durable Goods	1,786.5	4.0%	1,808.5	5.0%	1,826.3	4.0%	1,844.3	4.0%	1,595.1	5.5%	1,701.8	6.7%
Non-Durables	2,628.5	3.0%	2,651.2	3.5%	2,674.1	3.5%	2,697.2	3.5%	2,514.3	2.8%	2,574.4	2.4%
Services	7,767.1	2.2%	7,813.3	2.4%	7,859.8	2.4%	7,906.5	2.4%	7,507.3	2.3%	7,674.0	2.2%
Gross Private Domestic Invest.	**3,018.7**	**2.2%**	**3,069.4**	**6.9%**	**3,118.1**	**6.5%**	**3,165.9**	**6.3%**	**2,858.2**	**-1.6%**	**2,950.2**	**3.2%**
Bus. Fixed Invest.	2,398.4	5.9%	2,433.2	5.9%	2,470.8	6.3%	2,509.0	6.3%	2,210.4	-0.6%	2,313.9	4.7%
Structures	472.6	2.0%	477.3	4.0%	484.3	6.0%	491.4	6.0%	446.4	-4.1%	470.4	5.4%
Equipment	1,160.9	7.0%	1,183.4	8.0%	1,206.4	8.0%	1,229.8	8.0%	1,047.8	-3.4%	1,098.2	4.8%
Intellectual Property Products	766.9	4.0%	774.4	4.0%	782.1	4.0%	789.8	4.0%	720.4	6.3%	749.5	4.0%
Residential Invest.	605.3	0.0%	611.3	4.0%	617.3	4.0%	621.9	3.0%	587.5	5.5%	598.0	1.8%
Change in Inventory	15.0	-	25.0	-	30.0	-	35.0	-	33.4	-	13.3	-
Net Exports	**-661.3**	-	**-669.2**	-	**-673.2**	-	**-677.4**	-	**-586.3**	-	**-621.4**	-
Exports	2,247.0	3.0%	2,264.3	3.1%	2,280.5	2.9%	2,294.6	2.5%	2,120.1	-0.3%	2,191.6	3.4%
Imports	2,908.3	3.6%	2,933.4	3.5%	2,953.7	2.8%	2,972.0	2.5%	2,706.3	1.3%	2,813.0	3.9%
Gov't Purchases of Goods & Services	**2,930.1**	**1.3%**	**2,939.6**	**1.3%**	**2,949.2**	**1.3%**	**2,958.8**	**1.3%**	**2,900.2**	**0.8%**	**2,903.1**	**0.1%**
Federal	1,131.0	1.7%	1,133.9	1.0%	1,136.7	1.0%	1,139.5	1.0%	1,114.6	0.0%	1,116.5	0.2%
National Defense	682.8	2.0%	684.5	1.0%	686.2	1.0%	687.9	1.0%	667.0	-0.7%	668.6	0.2%
Non-Defense	448.3	1.5%	449.4	1.0%	450.5	1.0%	451.6	1.0%	447.0	1.2%	447.3	0.1%
State & Local	1,799.1	1.5%	1,805.8	1.5%	1,812.5	1.5%	1,819.3	1.5%	1,783.7	1.2%	1,784.7	0.1%
Real Final Sales	17,401.9	3.7%	17,535.1	3.1%	17,671.4	3.1%	17,807.4	3.1%	16,664.1	1.9%	17,060.1	2.4%
Real Domestic Final Sales	18,063.2	3.9%	18,204.2	3.2%	18,344.6	3.1%	18,484.9	3.1%	17,250.3	2.1%	17,678.9	2.5%
y/y	3.0%		3.1%		3.1%		3.3%					

	1st QUARTER 19 Forecast		2nd QUARTER 19 Forecast		3rd QUARTER 19 Forecast		4th QUARTER 19 Forecast		2018 FORECAST		2019 FORECAST	
Real GDP	**17,964.2**	**2.8%**	**18,092.1**	**2.9%**	**18,207.3**	**2.6%**	**18,305.7**	**2.2%**	**17,630.2**	**3.1%**	**18,142.3**	**2.9%**
Personal Consumption Expenditures	**12,485.2**	**3.0%**	**12,573.2**	**2.8%**	**12,653.9**	**2.6%**	**12,721.4**	**2.2%**	**12,260.9**	**3.1%**	**12,608.4**	**2.8%**
Durable Goods	1,862.4	4.0%	1,876.3	3.0%	1,890.2	3.0%	1,897.2	1.5%	1,816.4	6.7%	1,881.5	3.6%
Non-Durables	2,720.4	3.5%	2,747.3	4.0%	2,774.3	4.0%	2,794.9	3.0%	2,662.7	3.4%	2,759.2	3.6%
Services	7,953.6	2.4%	8,000.9	2.4%	8,040.6	2.0%	8,080.5	2.0%	7,836.7	2.1%	8,018.9	2.3%
Gross Private Domestic Invest.	**3,221.8**	**7.2%**	**3,255.2**	**4.2%**	**3,282.7**	**3.4%**	**3,304.3**	**2.7%**	**3,093.0**	**4.8%**	**3,266.0**	**5.6%**
Bus. Fixed Invest.	2,555.8	7.7%	2,584.5	4.6%	2,607.3	3.6%	2,629.2	3.4%	2,452.8	6.0%	2,594.2	5.8%
Structures	499.8	7.0%	507.1	6.0%	514.6	6.0%	520.9	5.0%	481.4	2.3%	510.6	6.1%
Equipment	1,256.6	9.0%	1,272.1	5.0%	1,281.5	3.0%	1,291.0	3.0%	1,195.1	8.8%	1,275.3	6.7%
Intellectual Property Products	801.4	6.0%	807.3	3.0%	813.3	3.0%	819.3	3.0%	778.3	3.8%	810.3	4.1%
Residential Invest.	631.0	6.0%	635.7	3.0%	640.4	3.0%	645.1	3.0%	613.9	2.7%	638.0	3.9%
Change in Inventory	35.0	-	35.0	-	35.0	-	30.0	-	26.3	-	33.8	-
Net Exports	**-682.4**	-	**-685.5**	-	**-688.2**	-	**-688.7**	-	**-670.3**	-	**-686.2**	-
Exports	2,311.6	3.0%	2,329.4	3.1%	2,346.1	2.9%	2,360.6	2.5%	2,271.6	3.7%	2,336.9	2.9%
Imports	2,994.1	3.0%	3,014.8	2.8%	3,034.2	2.6%	3,049.3	2.0%	2,941.9	4.6%	3,023.1	2.8%
Gov't Purchases of Goods & Services	**2,970.7**	**1.6%**	**2,980.3**	**1.3%**	**2,990.0**	**1.3%**	**2,999.8**	**1.3%**	**2,944.4**	**1.4%**	**2,985.2**	**1.4%**
Federal	1,144.6	1.8%	1,147.5	1.0%	1,150.3	1.0%	1,153.2	1.0%	1,135.3	1.7%	1,148.9	1.2%
National Defense	691.3	2.0%	693.0	1.0%	694.7	1.0%	696.5	1.0%	685.3	2.5%	693.9	1.2%
Non-Defense	453.3	1.5%	454.4	1.0%	455.6	1.0%	456.7	1.0%	449.9	0.6%	455.0	1.1%
State & Local	1,826.1	1.5%	1,832.9	1.5%	1,839.7	1.5%	1,846.6	1.5%	1,809.2	1.4%	1,836.3	1.5%
Real Final Sales	17,929.2	2.8%	18,057.1	2.9%	18,172.3	2.6%	18,275.7	2.3%	17,603.9	3.2%	18,108.6	2.9%
Real Domestic Final Sales	18,611.6	2.8%	18,742.6	2.8%	18,860.5	2.5%	18,964.4	2.2%	18,274.2	3.4%	18,794.8	2.8%
y/y	3.1%		3.0%		2.9%		2.6%					

Source: Historical Statistics - U.S. Dept. of Commerce, Bureau of Economic Analysis; Projections - Internal Estimates.

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住所：〒100-0011　東京都千代田区内幸町1-1-1　帝国ホテルタワー１１階
電話：03-3519-7880（代表）　ファックス：03-3519-6410
代表者：代表取締役社長　板垣 均

ホームページ：http://www.principalglobal.jp
金融商品取引業者登録番号：関東財務局長（金商）第462号
加入協会：一般社団法人　日本投資顧問業協会
一般社団法人　投資信託協会