Principal Global Investors

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Economic Insights

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

Topic summaries:

- **What happens after a crisis?**

  A return to normal. The world economic expansion, now two years old, remains intact, albeit with modest deceleration outside the United States.

- **The new Fed; same as the old Fed:**

  Even after several nominations, the new Federal Reserve (Fed) will follow the gradual rate path of the old Fed. The long downtrend in bond yields and policy rates is over.

- **Asset allocation: Is the correction over?**

  Probably not yet. But, another stock market rally is likely before rising yields and earnings disappointments put a cap on stock prices.

For the month of April 2018

What happens after a crisis?

A return to normal, at least eventually. Two years ago, a prolonged period of crisis came to an end. It began with the global financial crisis starting in the United States, then the European debt crisis, followed by a collapse in commodity prices that brought crises in emerging markets. Finally, China endured a stock market plunge and a surprise currency devaluation in 2015. Commodity prices hit a trough in early 2016, coincident with a peak in the U.S. dollar, and an economic recovery propelled a synchronized global expansion from mid-2016 through today.

Now that the crisis has passed, the world economy is starting to look normal. U.S. consumers are no longer deleveraging, household debt has surpassed its previous high, the household savings rate has fallen, and confidence is buoyant. The European debt crisis is a distant memory; periphery-country government bond yields have been stable for many years and Greece is running a budget surplus. Around the world, emerging economies have rebounded; Brazil and Russia are no longer in recession and India is growing fast again. While overall global growth likely peaked over the last two quarters, the pace of global economic activity is robust and should remain so into 2019.

United States:

Another first quarter, another soft patch. Growth of U.S. inflation-adjusted GDP in the first quarter fell below the pace of the last few quarters, similar to past years. Gains in consumer and residential spending were weak, but softening is likely temporary. Other parts of the report suggest strong underlying momentum. GDP rose 2.3% on a quarter-over-quarter annualized basis, but was up 2.9% over the prior year, a strong showing.

Following a boost from hurricane-related replacement spending in the third quarter, consumption was up a tepid 1.1% and housing activity was flat. Investment was strong, adding 1.2 percentage points to GDP growth. Capital spending on buildings jumped 12.3%. Inventory growth added 0.43 percentage points after detracting about a half of a percentage point last quarter. Net exports also added to GDP after taking off over a point last quarter. So, the overall weakness was in real final sales to domestic purchasers, up 1.6%.

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>
> Bob Baur • Chief Global Economist, Principal Global Investors

But, job gains have been excellent and robust confidence should boost consumer spending the rest of the year. Retail sales have already started to recover, with March sales up 0.6% after three months of declines. The Conference Board's Consumer Confidence Index surprised to the upside and the Bloomberg Weekly Consumer Comfort Index was the highest since 2000.

Wage growth is starting to pick up and is a key pillar of our optimism. The latest employment-cost index rose 2.7% year-over-year, the best pace of the expansion, with private wages and salaries up 2.9%. Sales of new and existing homes were robust the last two months, suggesting first quarter's flat residential spending was transitory. Regional Federal Reserve (Fed) surveys of manufacturers have been somewhat mixed. We still expect U.S. GDP gains this year to be 3% or more. Forecast tables are at the back of report.

Outside the United States:

There are signs economic growth has decelerated mildly. In Japan, after growth of over 2% for two quarters in mid-2017, we expect the economy to grow 1% to 1.5% this year. Business surveys in Japan rose a bit in April after a significant decline in March. Export growth has weakened from an 18% gain last August to 2.1% in March. Industrial production did bounce back for a second month in March. At an incredibly low 2.5%, the unemployment rate is the lowest since the mid-1990s. As the labor market continues to tighten, we expect inflation to continue its slow crawl upward. A robust job market should support growth as well.

In the Eurozone, the growth deceleration is stark. As noted last week, Euro area economic data surprised sharply to the downside in recent months. French GDP growth decelerated from 0.7% quarter-over-quarter in the fourth quarter, to 0.3% last quarter. U.K. GDP grew at only a 0.1% pace. Germany's IFO Business Climate Index lost even more momentum. The good news is business surveys and economic sentiment stabilized in April. And during April, the negative economic surprises troughed as well. The jobless rate in Germany held at a record low 5.3%. We look past the first-quarter weakness and expect GDP growth of 2% to 2.5% this year.

According to seasonal adjustment by J.P. Morgan, growth in China picked up slightly in the first quarter to 6.9% over the prior quarter, versus 6.7% in the fourth quarter. March retail sales were better than expected, rising 10.1%. Industrial production growth decelerated from 6.2% to 6.0%. Fixed asset investment also lost momentum. Exports dropped 2.7% after two very strong months at the start of the year. According to Bloomberg Intelligence, new total social financing, the broadest measure of credit growth, was down 19.4% year-over-year in the first quarter. The People's Bank of China cut the reserve requirement ratio by 1% mid-month, a sign that the government is trying to engineer financial tightening without hitting growth too hard. But, economic goals of slowing debt growth and cutting pollution are not growth friendly. We expect China to grow in the low 6% range this year.

The global expansion that started in early 2016 remains in place. Growth may decelerate from last year's pace but is still set to be strong. GDP reports in the United States and Europe were somewhat soft, but that weakness should be temporary. We expect 2018 to see U.S. growth of 3% or more with modest deceleration in the rest of the world.

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The new Fed; same as the old Fed

The Fed has operated for many months with several vacancies. President Trump made two more nominations to the Fed in April: Richard Clarida, global strategic advisor for PIMCO, former assistant secretary of the Treasury, and Columbia University professor; and Michelle Bowman, Kansas State Bank commissioner. Clarida was nominated to be the Fed's vice chair, Bowman as community bank representative. If these two nominations along with that of Marvin Goodfriend are confirmed, and we include the prior appointments of Jay Powell as Fed Chair and Randal Quarles as vice chair for supervision, President Trump will have remade the Fed board of governors to an extent unmatched in decades.

The surprise to many pundits is that this new Fed looks little different in expertise, philosophy, or temperament from the old Fed. While Powell's background was in finance rather than economics, Clarida and John Williams, who was recently named New York Fed President and a permanent voting member of the Federal Open Market Committee (FOMC), are very strong monetary economists. The new Fed will still be steeped in economic theory but will also have a strong background in financial markets. So, the pervasive fear that Trump appointees would be ideologues or susceptible to political pressure did not materialize.

Nothing about the nominations seems to have had any impact on the bond market. Yields on 10-year U.S. treasury bonds mostly held their strong gains since January with only a quarter point setback during the stock market volatility in February and March. Those yields surged in April, breaching the 3% barrier and closing the last full week of April at 2.96%, near a six-year high. Yields on 10-year German bunds also pushed somewhat higher ending that last week at 0.57%. Recent U.S. rate history is shown below.

Interest Rates

	12/31/2015	12/31/2016	12/29/2017	04/25/2018 (High)*	09/07/2017 (Low)*	04/27/2018 Current
2 year	1.05%	1.19%	1.88%	2.49%	1.27%	2.48%
10 year	2.27%	2.44%	2.41%	3.03%	2.04%	2.96%
10-2 spread	1.22%	1.25%	0.53%	0.54%	0.77%	0.48%
30 year	3.02%	3.07%	2.74%	3.21%	2.66%	3.12%

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

Gradual still means gradual:

Even with new members, the Fed will likely stick to its long-advertised path to normalize monetary policy carefully and slowly. Inflation will keep edging higher, but should not be prone to spikes. We don't expect the Fed to be aggressive or forceful as it reverses a decade of experiments in extraordinary policy. We look for two more hikes in the federal funds rate (FFR) in 2018 and perhaps two more in 2019. Those four new FFR increases through next year would put the FFR in a range of 2.5% to 2.75%, which is likely close to neutral. Bond market pundits as well as FOMC member rate expectations suggest eight or more Fed hikes before the rate increase cycle is over. That would push the FFR to more than 3.5%, which seems very excessive unless the economy overheats or inflation spikes. Neither possibility is evident now.

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Upside risk to long-bond yields:

The forces that held down inflation and bond yields for a decade are changing. First, the down-pressure on inflation from globalization is fading. For years, inflation stayed low as hundreds of millions of low-wage, underemployed workers entered the world labor force in droves, when trade restrictions fell after the World Trade Organization was created. Low-wage workers don't stay that way. As wages in China have risen at low double-digit rates for nearly two decades, U.S. manufacturing costs are very little higher than similar costs in China, according to the Boston Consulting Group. With fewer low-wage workers entering international commerce, inflation won't stay low like in the past.

Further, world growth is still well above trend after two years of robust expansion, and labor markets are tightening. The U.S. jobless rate is a low 4.1%. In Japan, it is incredibly small with 1.59 job openings for every job applicant. The Eurozone jobless rate is about 8.5% and has fallen a full point over the last year. Years of excess spare capacity and the chronically low inflation it spawned are fading. A tight labor market implies rising wage gains; the recent U.S. employment cost index is rising at the fastest rate of the expansion. German labor unions have won pay gains near or above 3%, the most in years. Healthy wage gains and high capacity utilization will bring higher inflation.

Central banks are becoming less accommodative. The Fed is actively reducing its bond portfolio and raising the FFR. The European Central Bank has reduced its bond purchases and will likely end them in December. Other central banks have raised rates. U.S. tax reform has spurred confidence and business activity. U.S. fiscal policy will lead to more U.S. treasury bond issuance.

Last, U.S. nominal GDP growth has been around 5% for three quarters. 10-year U.S. treasury bond yields below 3% are too low to be compatible with that vigorous level of growth. For all these reasons, the risk to long-term bond yields is surely to the upside and investors will have to get used to higher yields. The good news is financial conditions are still quite accommodative and should remain so as any inflation rise will be moderate.

A very slow rise:

While bond yields and policy rates have surely ended their three-decade downtrend, long-term interest rates may take a lengthy period to return to normal. Bond yields tend to move in waves: a surge up followed by a pause as financial markets adjust. So, the April move above 3% could be the top for this upturn. In addition, traders have record high short positions in U.S. treasury bonds, a fact that suggests the move higher in yields is over for now. If so, that would give the stock market some room for another rally back to or beyond the January highs. Since it would not be surprising for the stock market to encounter difficulties in 2019, our forecast for future interest rates may seem subdued given the economic vigor around the world. Those estimates are in the table below.

Interest Rates	Year-end 2018	Year-end 2019
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%	3.0%-3.25%
2-10 Year Spread	0.5%	0.25%-0.5%

April asset allocation: Is the correction over?

Maybe not just yet. The S&P 500 Index lost about 9% from the high closing price on January 26 to the low close on February 8; that's a bit less than is typical for a correction not associated with recession. And the 90 days since the peak is about the minimum duration for a significant correction. Further, sizeable downdrafts like this one often don't end without a spreading fear that it will turn into a full-fledged bear market. So far, any such pessimism is absent. Polls show investors are still complacent; that's also the message of the put/call ratio and the proportion of assets in the Rydex long versus short funds. So, stock markets could easily have another downdraft, especially if the recent upturn in long-term bond yields is not over. Unlike the investment consensus, we've not yet advised "buying the dip." However, if another wave down does occur along with rising pessimism, that might be the time to buy back into equities.

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Another rally?

Once this correction runs its course and bond yields stabilize, though, we look for stock prices to move higher, back to the January highs or perhaps beyond. Interest rates at their current higher levels don't seem to be dimming confidence or the prospects for capital spending and U.S. housing activity. The rising cost of debt has not yet negatively impacted earnings. Financial conditions remain very easy even though the Fed and a few other central banks are becoming a bit less accommodative. Inflation is edging higher, but, it's not likely to be enough to cause central banks to become more aggressive.

The economic backdrop for another equity rally is solid. The world expansion is clearly intact, albeit with modest deceleration outside the United States. First-quarter earnings are excellent and profit growth should stay robust and will extend the strong gains in business investment. Vigorous capital spending will generate better productivity growth and foster higher real household income growth. Improving U.S. and Eurozone wage gains will keep consumer spending healthy. Overall business, consumer, and employment indicators show no sign of recession anytime soon.

We expect the next move higher in stocks, if it comes, to be led by U.S. stocks and likely by the growth universe that has been the strongest over the last several years. For some time, the investment consensus has been expecting emerging market stocks to be performance leaders. That's been a mistake this year. The current environment of rising interest rates, a stronger dollar, and a peak in the pace of global growth is not a good one for emerging market stocks or bonds. Fixed income investors should consider bonds with shorter maturities.

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Baseline Economic Forecasts for 2018 - 2019

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

	1st Quarter 18 Actual		2nd Quarter 18 Forecast		3rd Quarter 18 Forecast		4th Quarter 18 Forecast		2016 Actual		2017 Actual	
Real GDP	**17,385.8**	**2.3%**	**17,528.8**	**3.3%**	**17,664.8**	**3.1%**	**17,810.5**	**3.3%**	**16,716.2**	**1.5%**	**17,096.2**	**2.3%**
Personal Consumption Expenditures	**12,066.8**	**1.1%**	**12,168.9**	**3.4%**	**12,255.6**	**2.9%**	**12,342.9**	**2.9%**	**11,572.1**	**2.7%**	**11,890.7**	**2.8%**
Durable Goods	1,754.0	-3.3%	1,771.3	4.0%	1,788.8	4.0%	1,806.4	4.0%	1,595.1	5.5%	1,701.6	6.7%
Non-Durables	2,612.5	0.1%	2,631.8	3.0%	2,654.6	3.5%	2,677.5	3.5%	2,514.3	2.8%	2,575.0	2.4%
Services	7,769.5	2.1%	7,815.7	2.4%	7,862.2	2.4%	7,908.9	2.4%	7,507.3	2.3%	7,675.2	2.2%
Gross Private Domestic Invest.	**3,064.4**	**7.3%**	**3,102.9**	**5.1%**	**3,146.6**	**5.8%**	**3,199.5**	**6.9%**	**2,858.3**	**-1.6%**	**2,952.3**	**3.3%**
Bus. Fixed Invest.	2,400.8	6.1%	2,436.2	6.0%	2,473.9	6.3%	2,512.2	6.3%	2,210.4	-0.6%	2,314.2	4.7%
Structures	488.6	12.3%	493.4	4.0%	500.6	6.0%	508.0	6.0%	446.4	-4.1%	471.5	5.6%
Equipment	1,154.1	4.7%	1,176.5	8.0%	1,199.4	8.0%	1,222.7	8.0%	1,047.8	-3.4%	1,098.1	4.8%
Intellectual Property Products	763.1	3.6%	770.6	4.0%	778.2	4.0%	785.9	4.0%	720.4	6.3%	748.8	3.9%
Residential Invest.	605.0	0.0%	611.0	4.0%	617.0	4.0%	621.6	3.0%	587.4	5.5%	597.9	1.8%
Change in Inventory	33.1	-	30.0	-	30.0	-	40.0	-	33.4	-	15.2	-
Net Exports	**-645.9**	**-**	**-653.7**	**-**	**-657.6**	**-**	**-661.7**	**-**	**-586.2**	**-**	**-621.8**	**-**
Exports	2,256.3	4.8%	2,273.6	3.1%	2,289.9	2.9%	2,304.1	2.5%	2,120.1	-0.3%	2,191.4	3.4%
Imports	2,902.2	2.6%	2,927.2	3.5%	2,947.5	2.8%	2,965.8	2.5%	2,706.3	1.3%	2,813.2	4.0%
Gov't Purchases of Goods & Services	**2,930.0**	**1.2%**	**2,939.7**	**1.3%**	**2,949.3**	**1.3%**	**2,958.9**	**1.3%**	**2,900.2**	**0.8%**	**2,903.3**	**0.1%**
Federal	1,131.0	1.7%	1,134.0	1.1%	1,136.8	1.0%	1,139.6	1.0%	1,114.6	0.0%	1,116.4	0.2%
National Defense	682.3	1.8%	684.0	1.0%	685.7	1.0%	687.4	1.0%	667.0	-0.7%	668.6	0.2%
Non-Defense	448.3	1.6%	449.4	1.0%	450.5	1.0%	451.6	1.0%	447.0	1.2%	447.2	0.1%
State & Local	1,797.2	0.8%	1,803.9	1.5%	1,810.6	1.5%	1,817.4	1.5%	1,783.6	1.2%	1,785.0	0.1%
Final Sales of Dom. Product	17,332.3	1.9%	17,480.3	3.5%	17,616.2	3.1%	17,751.9	3.1%	16,664.1	1.9%	17,062.0	2.4%
Final Sales to Dom. Purchasers	17,973.4	1.6%	18,132.8	3.6%	18,272.7	3.1%	18,412.5	3.1%	17,250.3	2.1%	17,681.2	2.5%
y/y	2.9%		2.9%		2.9%		3.0%					

	1st Quarter 19 Forecast		2nd Quarter 19 Forecast		3rd Quarter 19 Forecast		4th Quarter 19 Forecast		2018 Forecast		2019 Forecast	
Real GDP	**17,952.7**	**3.2%**	**18,087.7**	**3.0%**	**18,207.8**	**2.7%**	**18,314.9**	**2.4%**	**17,597.5**	**2.9%**	**18,140.8**	**3.1%**
Personal Consumption Expenditures	**12,430.8**	**2.9%**	**12,522.7**	**3.0%**	**12,605.0**	**2.7%**	**12,681.1**	**2.4%**	**12,208.5**	**2.7%**	**12,559.9**	**2.9%**
Durable Goods	1,824.2	4.0%	1,842.2	4.0%	1,855.8	3.0%	1,869.6	3.0%	1,780.1	4.6%	1,848.0	3.8%
Non-Durables	2,700.6	3.5%	2,727.2	4.0%	2,754.1	4.0%	2,774.5	3.0%	2,644.1	2.7%	2,739.1	3.6%
Services	7,956.0	2.4%	8,003.3	2.4%	8,045.0	2.1%	8,086.9	2.1%	7,839.1	2.1%	8,022.8	2.3%
Gross Private Domestic Invest.	**3,246.7**	**6.0%**	**3,283.1**	**4.6%**	**3,313.9**	**3.8%**	**3,335.6**	**2.6%**	**3,128.3**	**6.0%**	**3,294.8**	**5.3%**
Bus. Fixed Invest.	2,550.3	6.2%	2,582.0	5.1%	2,608.1	4.1%	2,630.1	3.4%	2,455.8	6.1%	2,592.6	5.6%
Structures	516.6	7.0%	524.2	6.0%	531.9	6.0%	538.4	5.0%	497.6	5.5%	527.8	6.1%
Equipment	1,240.6	6.0%	1,258.8	6.0%	1,271.3	4.0%	1,280.7	3.0%	1,188.2	8.2%	1,262.9	6.3%
Intellectual Property Products	797.4	6.0%	803.4	3.0%	809.3	3.0%	815.3	3.0%	774.5	3.4%	806.4	4.1%
Residential Invest.	630.7	6.0%	635.3	3.0%	640.1	3.0%	644.8	3.0%	613.6	2.6%	637.7	3.9%
Change in Inventory	40.0	-	40.0	-	40.0	-	35.0	-	33.3	-	38.8	-
Net Exports	**-666.6**	**-**	**-669.5**	**-**	**-672.1**	**-**	**-672.6**	**-**	**-654.7**	**-**	**-670.2**	**-**
Exports	2,321.2	3.0%	2,338.9	3.1%	2,355.7	2.9%	2,370.3	2.5%	2,281.0	4.1%	2,346.5	2.9%
Imports	2,987.8	3.0%	3,008.5	2.8%	3,027.8	2.6%	3,042.9	2.0%	2,935.7	4.4%	3,016.7	2.8%
Gov't Purchases of Goods & Services	**2,970.7**	**1.6%**	**2,980.4**	**1.3%**	**2,990.1**	**1.3%**	**2,999.8**	**1.3%**	**2,944.5**	**1.4%**	**2,985.2**	**1.4%**
Federal	1,144.7	1.8%	1,147.6	1.0%	1,150.4	1.0%	1,153.3	1.0%	1,135.4	1.7%	1,149.0	1.2%
National Defense	690.8	2.0%	692.5	1.0%	694.3	1.0%	696.0	1.0%	684.9	2.4%	693.4	1.2%
Non-Defense	453.3	1.5%	454.4	1.0%	455.6	1.0%	456.7	1.0%	450.0	0.6%	455.0	1.1%
State & Local	1,824.2	1.5%	1,831.0	1.5%	1,837.8	1.5%	1,844.6	1.5%	1,807.3	1.2%	1,834.4	1.5%
Final Sales of Dom. Product	17,894.1	3.2%	18,029.1	3.1%	18,149.2	2.7%	18,261.3	2.5%	17,545.2	2.8%	18,083.5	3.1%
Final Sales to Dom. Purchasers	18,559.6	3.2%	18,697.5	3.0%	18,820.2	2.7%	18,932.7	2.4%	18,197.9	2.9%	18,752.5	3.0%
y/y	3.3%		3.2%		3.1%		2.8%					

Source: U.S. Dept. of Commerce, Bureau of Economic Analysis; Principal Global Investors

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