ECONOMIC INSIGHTS
SPECIAL EDITION

2015 OUTLOOK GREAT UNWINDINGS

Bob Baur
Chief Global Economist
Principal Global Investors

Robin Anderson
Economist
Principal Global Investors

The Principal
Economic Committee

HIGHLIGHTS

- Economists at Principal Global Investors see the global economy in 2015 affected by the unwinding of several economic "springs."
- The end of the investment boom in China means the end of the commodity super-cycle and augers financial risk for emerging markets.
- Offshoring from the United States is turning to "reshoring."
- Several factors tamping down global inflation, which means interest rates could stay lower for longer.
- Expect lower returns and continued volatility in 2015.

In the 15th Century, clock makers began to use coiled springs to drive the movement of their timepieces. The biggest problem they faced was "unwinding." As the spring unwound, its power diminished, and the clock slowed. A clock could become erratic and unreliable as the spring ran down.

Until mechanical means were discovered to correct this problem, unwinding meant that spring-driven clocks would not keep good time unless they were constantly tended and kept wound. The global economy faces similar problems as 2015 approaches, with several economic "springs" around the world unwinding, potentially causing problems, but also creating opportunities. This paper will examine each of these unwindings and their investment impacts as we look forward to 2015.

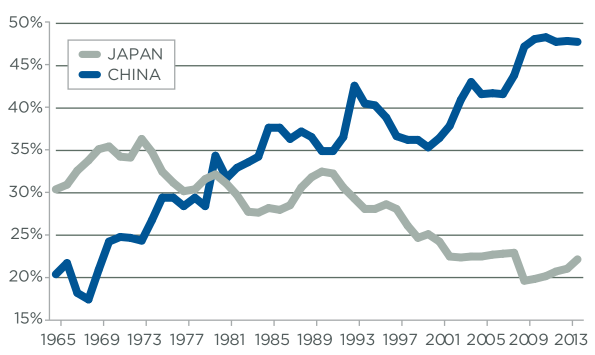
UNWINDING – CHINA'S INVESTMENT BOOM

China figured heavily in our outlook for 2014 because of its diminishing economic competitiveness. China is again a theme for 2015, because their decades-long investment boom is beginning to unwind. Since the 1980s, China's urbanization and industrialization have spawned a massive program of investment – building roads, factories, power grids, office buildings, airports, houses, even entirely new cities – whatever China needed to raise the living standards of its people.

China's less-competitive exports and increasing demand for high-quality consumer goods and services likely swing the pendulum back in favor of the United States.

Investment peaked at over 48% of China's GDP in 2011; no country had ever matched that feat in the modern world.

CHINA AND JAPAN:
Investment as a Percent of GDP



Source: 1965-1979 data from World Bank WDI, 1980-2014 IMF World Economic Outlook, October 2014.

Notes: *Gross fixed capital formation used prior to 1980.* 2014 data are forecasts from IMF World Economic Outlook, 2014.

China, the new economic powerhouse in Asia, has invested significantly more in itself than Japan, the previous economic heavyweight in the region, ever did. That massive investment program is now beginning to subside.

Compared to Japan, in its heyday as a prior Asian powerhouse, one can see stark differences in investment levels. Never in its development did Japan's investment account for even 40% of GDP. With this tremendous surge of investment, China shortened its development cycle from a typical 30- to 50-year process into the space of less than three decades.

The unwinding of the glory days of investment coincide with slowing economic growth. China's huge advantage at the beginning of its renaissance was an almost unlimited supply of underemployed and cheap workers. But, since China's economic opening by Deng Xiaoping in 1978, that vast supply has gradually been absorbed.

This growth slowdown has come about for several reasons. First, the labor force is shrinking because of the long-term impact of the one-child policy. Second, the boost to productivity, or output per hour, that comes from moving an underemployed farmer into a factory, has peaked; therefore, the growth of productivity is declining. It's still good, just growing at a slower pace. The third reason is diminished competitiveness. Because wages have soared in China as fewer underemployed workers were available for hire, China's economic competitiveness has eroded. Consequently, China is no longer the world's lowest-cost manufacturer. Wages in Mexico are the same or less than in China; so, Mexican manufacturing zones, or *maquiladoras*, that suffered through the 1990s are beginning to perk back up. Finally, China's huge two-decade surge in investment resulted in substantial excess productive capacity. As growth in investment slows, economic growth slows with it.

The effects will be felt far outside of China. Slower growth is a headwind for many emerging markets, especially those that supplied China with the commodities and raw materials needed to industrialize. Economies across South America, Africa, and Asia will all see less demand from China, likely one of their largest trade partners.

So, too, the economic relationship with the United States built up over the past 25 years is changing. The old bond described China as the manufacturer and the United States as the buyer. With its competitiveness in question, China's new model relies more on domestic consumption to drive their economy. China's less-competitive exports and increasing demand for high-quality consumer goods and services likely swing the pendulum back in favor of the United States.

As growth slows and the investment boom unwinds, the pace of demand for commodities in China is falling.

UNWINDING – THE COMMODITY SUPER-CYCLE

Our second unwinding is inextricably linked with the first. What has come to be known as the commodity super-cycle started in the late 1990s. Greater than the waxing and waning of commodity prices with the business cycle, the super-cycle was a decade-long surge, one record price after another for most commodities. It was directly driven by China's investment boom. As that economy industrialized and urbanized, China's incredible growth drove a demand for everything from, copper, nickel, and aluminum to iron ore and oil.

Broad Commodity Price Average

Source: Bloomberg

The End of a Commodity-Price Super-Cycle

After nearly two decades of surging commodity prices, slacking demand from China and increasing supply is reversing that trend.

That surge is over. Demand drove up prices for practically every type of commodity. But now, as growth slows and the investment boom unwinds, the pace of demand for commodities in China is falling. Those years of record prices were authoring their own demise. High prices curtailed demand, but provided the incentive for producers to significantly increase supply. With demand growth dwindling and supply rising, commodity prices have plunged. It all comes back to supply and demand. While prices may have a cyclical burst after severe declines, it is unlikely that commodities will see new inflation-adjusted peak prices anytime soon.

UNWINDING – THE BOOM IN U.S. OFFSHORING

Through much of the 1980s and 1990s, the rage among U.S. companies was to utilize cheap, underemployed workers abroad; raise profits by cutting labor costs. The economics favored shifting manufacturing to low-cost countries and shipping the goods back to the United States. This practice garnered the name "outsourcing" or "offshoring." That trend is unwinding and reversing, with companies now shifting manufacturing back to the United States.

Moving jobs back to the United States has huge implications. Manufacturing has long been the backbone of a strong middle class in the United States. As new manufacturing jobs were created in China and other low-cost labor economies rather than in the United States, this put tremendous pressure on U.S. middle-class wages. The result has been stagnant or sluggish incomes for some time. Rather than an aberration, this was part of globalization.

Outsourcing now seems like a relic in the United States. As this situation unwinds, the new buzzwords are "reshoring" and "insourcing." The key to this trend lies in U.S. labor productivity.

Manufacturing unit labor costs in the United States have been essentially flat for three decades, while unit labor costs in Asia and South America have risen. For perspective, it is not only global companies who are moving operations to the United States; Chinese companies are doing the same. They are making the move for a few different reasons. As the underemployed workers in China and elsewhere began to be absorbed into the global workforce, wages soared, up four or five times in China over the last 15 years. Second, significant inflation-adjusted currency appreciation in China has added dramatically to export costs for local manufacturers. Third, transportation costs are much higher, with oil prices at US$70 to US$80 rather than the US$11 per barrel of 1998. And last, there is a relative difference in the rule of law between China and the United States. Company research and intellectual property is seen by some as being more secure if operations are housed in the United States. So, companies looking at manufacturing in China for export to the United States are finding it's not nearly as cost effective any more.

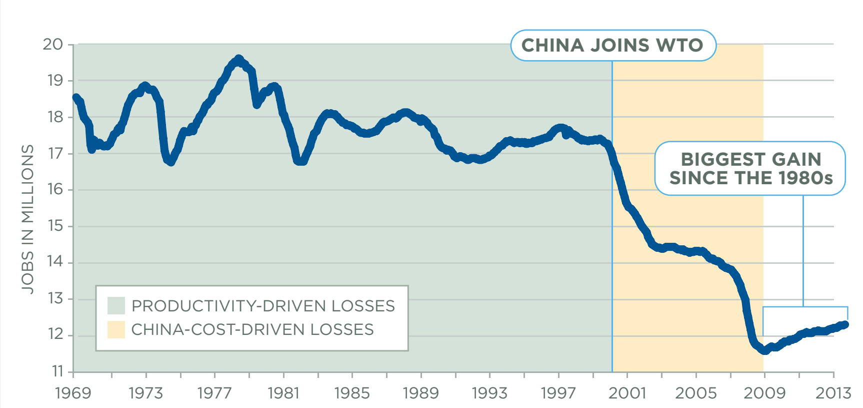
Beyond labor costs, higher commodity prices have been a tremendous boon to U.S. companies with technology that can reduce commodity inputs, find substitutes for over-priced commodities, or develop new supplies. The thriving shale oil and gas industry and the employment surge that has come with it is a great example.

UNWINDING – THE LONG-TERM U.S. CREDIT SUPER-CYCLE

As globalization expanded, the dearth of new manufacturing jobs and wage competition from abroad took a toll on U.S. middle-class incomes. Wages were under pressure, median income growth was sluggish, and a slowly growing inequality became a topic of conversation. However, despite stagnating middle-income wages in the late 1990s and early to mid-2000s, household spending was rising at a terrific rate. To keep up that fast spending growth, households turned more and more to borrowing. In the 2000s especially, households began to borrow the price appreciation out of their houses through home-equity loans. Total household debt as a portion of GDP reached record level after record level.

That surge is over. Chastened by the severe financial crisis, the plunge in house prices and the sight of friends and neighbors losing their homes, U.S. consumers rightfully concluded that borrowing the equity out of their homes was not a long-term financial solution. So, they have not reverted to old habits of borrowing to spend; constrained lending standards helped too. In turn, consumers are raising savings, paying down debt, keeping spending less than income, and borrowing at a much more conservative pace.

U.S. Manufacturing Employment – Offshoring Turns to Reshoring



After almost three decades, manufacturing in the United States has become economically competitive on a global scale. This is driving companies to move manufacturing jobs to the United States in levels not seen since the 1980s.

Source: The Bureau of Labor Statistics

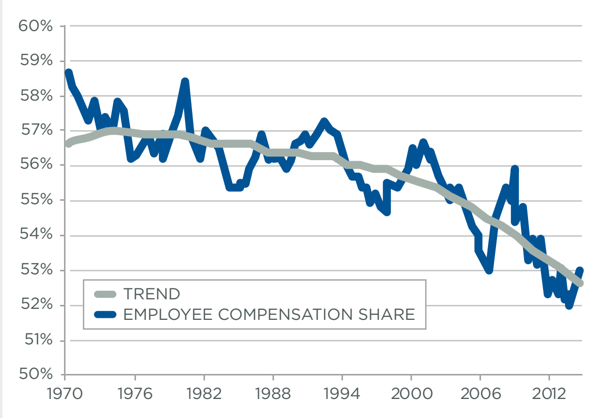
The initial advantage gained by businesses from the ability to arbitrage labor costs around the world has run its course.

UNWINDING – THE LONG SLIDE IN HOUSEHOLD INCOME SHARE

Another consequence of globalization, the resulting downward pressure on U.S. wages translated into a greater portion of total U.S. income being captured by business as profits. The capital saved on labor costs added to business profits and the household share of U.S. national income turned down. In some sense, this was a natural outcome of globalization; at least initially, businesses, as opposed to individual workers, were able to take advantage of the global reach of worldwide sales.

But, no cycle lasts forever. Wages soared in China and elsewhere, and the United States became competitive again. In turn, that advantage of business may be diminishing. As more companies are opening operations in the United States and unemployment is falling fast, U.S. wage growth is on the verge of picking up. In addition, the fall in global inflation is at least partially due to the excess productive capacity built as China industrialized. As a result, U.S. businesses will find it hard to raise end-product prices to offset higher wages. So, the initial advantage gained by businesses from the ability to arbitrage labor costs around the world has run its course. U.S. workers should begin to find some pricing power.

Share of Income Going to Business May Have Peaked



Source: The Bureau of Economic Analysis, NIPA Tables

With current economic trends, it looks like the percent of overall income going to workers could start rising. Businesses shouldn't worry though; rising wages will push demand higher and offset the hit to margins.

So, while it is potentially controversial, for these reasons it is likely that household income as a share of total U.S. income has already reached its nadir and will start to rise. If that is the case, the share of U.S. national income accruing to business will fall. Business profits will still increase; the rise in wages will likely push demand higher and the expansion in total revenue to business will offset the hit to margins from better wages.

GROWTH AND INVESTMENT IMPLICATIONS

FINANCIAL RISK IS IN EMERGING MARKETS

Developing countries enjoyed a decade of strong growth, surging commodity prices, spectacular equity market performance, and terrific profits driven mostly by the industrialization in China. During such long economic booms, imbalances always develop. Businesses expand, build plenty of capacity, and invest assuming that the fast growth will always be there; they borrow lots of credit assuming that the stupendous profit growth will continue and the debt will be easily repaid. However, the fast demand growth on which all that expansion, borrowing, and investment was based disappears. Profit growth plunges, currencies fall, and debt repayment becomes unbearable.

Emerging markets did not experience the same type of financial crises suffered by the United States and much of Europe from 2008 to 2012. So, the imbalances that surely built in China and emerging markets have not been cleansed. And at just the wrong time, the liquidity on which emerging markets thrive is diminishing. The U.S. dollar is strengthening; the Fed is gradually taking away its provisions of liquidity; and the U.S. trade deficit is shrinking. All these typical sources of global liquidity are shrinking. Emerging markets are at risk, but not all emerging markets are equally exposed. Commodity exporters and countries with closer trade ties to China are more vulnerable than commodity importers or countries relatively more aligned to the United States.

THE INFLATION TRADE IS OVER

With commodity prices plunging and excess capacity rampant throughout the world, inflation could stay low for some time. Markets are gradually coming to terms with that likelihood. The decline in the euro and the yen will also keep pressure on U.S. inflation. This is not bad deflation or secular stagnation for the United States; rather it is the result of a surge in investment in emerging markets and subdued consumer spending in the developed world.

INTEREST RATES COULD STAY LOWER FOR LONGER

Since the inflation component of rates could be lower than expected, as noted earlier, interest rates could stay at low levels for longer than expected. Even though the Fed has begun its own journey towards rate normalization, the downward pressure on interest rates will persist. New regulations after the financial crisis require institutions to hold a larger portion of their balance sheet in safe-haven assets. Much of the world, especially the Eurozone, is still deleveraging or unwilling to ratchet up debt as before. Most countries want a trade surplus, a symptom of an excess of savings. German bunds yielding only 0.7% or so make U.S. Treasurys at 2.20% look tempting. Easing policies in Japan and the Eurozone will also keep interest rates under pressure.

LOWER RETURNS AND VOLATILITY

Five years of zero interest rates have raised prices for most assets. Fixed income investors may struggle to find acceptable returns in 2015, with low rates and a lack of upside for prices. U.S. equity returns will depend more on earnings growth, since multiples will likely not expand. The U.S. economy is solid. So, U.S. equity returns in the upper single digits could be anticipated with earnings growth in the 5% to 8% range. But, with the Fed exiting its extraordinary accommodation, markets will likely be more volatile than investors have been used to. U.S. and global real estate may also represent an opportunity for investors. U.S. REITs were star performers in 2014, but are still below their previous peak. If rates remain low for longer, as we expect, REITs and other real estate assets will still be attractive for investors seeking yield.

GLOBAL GROWTH IS HEALING

None of the typical harbingers of recession are visible in the United States. The fear, so prominent after the severe financial crisis, that the economy is about to relapse in recession or worse is fading. So, consumer confidence is picking up for this and other reasons: gas prices are plunging; interest costs are very low; the job market is improving; and wages and salaries are rising. As a result, consumer spending growth could hit a faster pace of 2.5% or more, keeping U.S. growth above trend at 3% plus for a few quarters; growth could return to trend of 2.5% late in 2015. The slow and gradual expansion suggests that it could last longer than many expect, although it is surely well past the half-way mark already.

Pessimism abounds when the discussion turns to Europe. While it seems almost fashionable to be very negative on the Eurozone, we are somewhat more positive in light of recent data and some slender progress on structural change. Europe has not covered itself with glory in its attempts to rebuild its economy, but there may be a "green shoot" or two emerging on the Continent. Both France and Italy have made changes in the direction of a business-friendly environment. Spain, Ireland, and Greece have made significant structural reform; wages have fallen and unit labor costs have come down dramatically. Final demand is likely more resilient than believed. Retail sales are still rising and auto sales, while still very low, are climbing. Lending standards are easing, banks are willing to lend and loan demand is gradually picking up. The money supply has turned up. Economic growth could surpass 1% with a triple-dip recession not likely. However, all this better news is for naught if the Ukraine conflict worsens. Significantly more stringent sanctions on Russia could hit European exports, and in turn, drag down already fragile growth.

The situation is Japan is even more fluid. The recent shock-and-awe campaign – #2 from the Bank of Japan – coupled with the move by the giant state pension fund to invest more in stocks was a hit with markets. Postponing the second VAT hike and calling a snap election in December was a response to the second straight quarter of economic contraction; it is a gamble for Prime Minister Abe, but may enhance his ability to institute more difficult reforms. Under the surface, positive things are happening. Unemployment is very low; the labor market is tight; wages are beginning to rise; industrial production has turned higher; and the plunge in oil prices is a real positive for Japanese households and business. Japan should exit its technical recession in the fourth quarter.

The slowdown in China is continuing, but a hard landing is not in the picture. Growth will likely be around 6% or a bit more in 2015. Investment is shrinking as a portion of GDP as China rebalances to a more consumer-driven economy. A financial crisis should be avoided. Still, as credit fueled much of the investment spending over the last decade, many local governments and state-owned enterprises are highly leveraged.

POTENTIAL RISKS

The interconnected nature of the global economy means that if one major economy gets sick, the rest may start to show symptoms. The Eurozone needs economic reform. If that doesn't happen, is too late or half-hearted, the drag on the Eurozone and global growth will persist.

If the United States fails to deliver even the modest growth described above, the likely culprit will be a heavier regulatory environment than existed several years ago. Well-meaning legislation and regulations like the Affordable Care Act, the Dodd-Frank bill, the Environmental Protection Agency's involvement with U.S. utilities may provide benefits, but also create challenges and uncertainty for business. The National Federal of Independent Businesses (NFIB) reported that regulation remains the biggest problem for the largest share of small businesses owners since the early 1990s. According to PriceWaterhouseCooper's 2014 Global CEO Survey, 72% of CEOs thought overregulation was the top threat to growth, up from 69% and 56% in 2012 and 2013, respectively. Overly harsh regulatory burdens could cause U.S. economic growth to feel gravity's pull.

U.S. capital spending is another area to watch into 2015. Productivity growth needs to pick up, but will only do so if companies invest. If the U.S. economy gains momentum and the unemployment rate falls, the resulting wage growth will need to be accompanied by better productivity.

U.S. monetary policy is beginning to normalize. The Fed is transitioning from an extremely accommodative stance to one that is less so, and markets may be troubled. There will likely be two or three rate hikes in 2015, beginning in June, with the fed funds rate ending the year at 0.75% or 1.0%. Markets expect this transition, but that changeover has rarely happened without disruption. During Ben Bernanke's term as Fed chairman, markets swerved when their understanding of the chairman's statements did not mesh with Bernanke's intentions. And that was when rate hikes were years in the future.

CONCLUSION

Several springs that have helped power the global economy over recent decades are winding down. Those unwindings can present difficulties, but also opportunities. Markets are no stranger to volatility and these changes could mean a bit more.

We are generally positive on U.S. stocks, and developed-country equities more broadly, for the reasons stated throughout this paper. We are cautious in the near term on emerging market debt and equities because of potential financial stress. Investors may find decent returns in real estate in selected areas around the world. Fixed income investors may be disappointed, given current low rates and prospects that they may remain so. And while 2015 may not mirror the returns of previous years, it's best to remember the mantra of the late American physical fitness pioneer Bonnie Prudden, "You can't turn back the clock, but you can wind it up again."

DISCLOSURES

The information in this document has been derived from sources believed to be accurate as of December 2014. Information derived from sources other than Principal Global Investors or its affiliates is believed to be reliable; however we do not independently verify or guarantee its accuracy or validity.

The information in this document contains general information only on investment matters and should not be considered as a comprehensive statement on any matter and should not be relied upon as such nor should it be construed as specific investment advice, an opinion or recommendation. The general information it contains does not take account of any investor's investment objectives, particular needs or financial situation, nor should it be relied upon in any way as a forecast or guarantee of future events regarding a particular investment or the markets in general. All expressions of opinion and predictions in this document are subject to change without notice. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security.

Past performance is not a reliable indicator of future performance and should not be relied upon as a significant basis for an investment decision. You should consider whether an investment fits your investment objectives, particular needs and financial situation before making any investment decision.

Subject to any contrary provisions of applicable law, no company in the Principal Financial Group nor any of their employees or directors gives any warranty of reliability or accuracy nor accepts any responsibility arising in any other way (including by reason of negligence) for errors or omissions in this document.

All figures shown in this document are in U.S. dollars unless otherwise noted.

This document is issued in:

- The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.
- The United Kingdom by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London EC2V 7JB, registered in England, No. 03819986, which has approved its contents, and which is authorised and regulated by the Financial Conduct Authority.
- Singapore by Principal Global Investors (Singapore) Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act (Chapter 289).
- Hong Kong by Principal Global Investors (Hong Kong) Limited, which is regulated by the Securities and Futures Commission and is directed exclusively at professional investors as defined by the Securities and Futures Ordinance.
- Australia by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS Licence No. 225385), which is regulated by the Australian Securities and Investments Commission.
- This document is issued by Principal Global Investors LLC, a branch registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as a representative office and is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organisation. This document is intended for sophisticated institutional investors only.

In the United Kingdom this document is directed exclusively at persons who are eligible counterparties or professional investors (as defined by the rules of the Financial Conduct Authority). In connection with its management of client portfolios, Principal Global Investors (Europe) Limited may delegate management authority to affiliates that are not authorised and regulated by the Financial Conduct Authority. In any such case, the client may not benefit from all protections afforded by rules and regulations enacted under the Financial Services and Markets Act 2000.

Principal Global Investors is not a Brazilian financial institution and is not licensed to and does not operate as a financial institution in Brazil. Nothing in this document is, and shall not be considered as, an offer of financial products or services in Brazil.