Principal Global Investors

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Economic Insights

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

Topic summaries:

- ***The Italian job:***
  Almost like Mark Wahlberg's character, extreme market turmoil may have prevented a worse outcome. Problems remain but Italy's new government may have an opportunity to function.

- **Economic divergence and recovery:**
  Healthy world growth should persist into 2019, but the dynamics have changed. The pace of activity outside the United States has downshifted modestly, even as the U.S. economy steams ahead.

- **The path to normal policy:**
  The path includes higher interest rates, but how high and when are the questions. We think the uptrend in long rates will pause and the Federal Reserve (Fed) will stay gradual.

- **Asset allocation: Time for a rally?**
  Likely so; technical and economic signals are positive for equities. But, it may be the last of this cycle; stick with U.S. stocks.

For the month of May 2018

The Italian job

It's interesting how populist leaders, even socialist types, can be so sensitive to market signals. That's surely the implication of the sudden formation of a new government in Italy only days after a massive bond and stock market kerfuffle on May 29 and 30. The FTSE MIB stock index in Italy plunged 4.7% over those two days, and the yield on two-year Italian bonds leapt six times from 0.44% to 2.64%.

It began with a veto by Italian President Sergio Mattarella of the new government formed by the populist Five Star and center-right alliance led by Lega Nord, the two largest vote recipients in the March 4 election. The veto resulted from the potential appointment of Paolo Savona as finance minister, who is openly opposed to Italy's membership in the Eurozone. The president thought it inappropriate as Eurozone membership was not an issue in the election. The situation rapidly deteriorated with threats to impeach the president and call a new election where populists might gain even more ground. Order was restored late week after the groups reformed their alliance with Savona in a far less influential post. Stock markets soared and bond yields plunged.

Mark Wahlberg's character in the movie might be proud of what the market rout accomplished. The likely message is that public ardor for provocative policies dwindles quickly when serious financial consequences become evident.

The new government stopped the hemorrhaging, but the problems of poor productivity and high debt remain. The positives are that growth has improved, the budget has some limited space for fiscal expansion, and a sizeable majority of Italians favor remaining in the Eurozone. Further, after the agony of Brexit, Brussels may be more flexible and avoid full confrontation with the new alliance. The political risk is still there, but it's been pushed down the road.

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> Healthy world growth should persist into 2019, but the dynamics have changed.
>
> Bob Baur • Chief Global Economist, Principal Global Investors

Economic divergence and recovery

With markets riding a rollercoaster of risk and recovery the last week of May, it's good to note many positive economic signals. Nevertheless, the dynamics of world growth have shifted. Last year, all the countries tracked by the Organization for Economic Cooperation and Development (OECD) were growing and, in over two-thirds, growth had accelerated. This year, not quite so strong. Last year, Europe and Japan were growing well above trend; developing countries were benefitting from rising commodity prices and a widespread pickup in world trade. This year, not so much, as the synchrony of growth ended. The pace of economic activity outside the United States has shifted down modestly, while the U.S. economy steams ahead with increasing momentum. Beyond the modest growth moderation, the world expansion should persist well into 2019.

› Eurozone decelerates:

Economic data across the Euro area weakened gradually as the year wore on. Business surveys of service and manufacturing businesses were ultra-robust in January, but softened to levels consistent with about 2% growth. Real GDP grew only 1.7% in the first quarter, down from 2.7% in the fourth quarter. Economic sentiment from the European Commission slipped a bit, but is still not far from a 17-year high. March industrial production was 3% above the prior year, versus 5.1% in December.

Several reasons are behind the slowdown: mostly one-off factors like heavy snowstorms, employee strikes, flu, extra holidays, etc. The currency strengthened over the last year from 1.11 U.S. dollars/euro to 1.24 in April, hurting Europe's export engine. Europe, especially Germany, could be hitting capacity constraints, with utilization above 84%, not far from a record high. Delivery times from manufacturing suppliers are super-slow. Trade tensions and political risk could also be curbing output.

Growth should rebound to 2% to 2.5% as some of the weakness is fleeting. The euro has fallen to 1.16 versus the U.S. dollar; German retail sales are surging; wage growth is picking up; and the jobless rate keeps falling, now at 8.5%, the lowest since early 2009. Euro area inflation is the highest in over a year, close to the European Central Bank (ECB) target. The risk is geopolitical; the change in Italian and Spanish governments may prevent an upside to growth.

› Japan downside surprise:

Tough winter weather may also have been a problem in Japan as GDP shrank last quarter for the first time in two years. A second-quarter recovery is clearly underway even though the data is mixed. Surveys of manufacturing businesses fell again in May, but, export growth rebounded in April and retail sales surprised higher. Wage growth is picking up as the jobless rate maintained its near multi-decade low of 2.5%. There are now 159 full-time job openings for every 100 job applicants. GDP data in Japan are volatile and often highly revised from the initial estimate. Even if the GDP contraction remains, it is likely temporary, as strong labor markets and better wages should support domestic demand.

› A slower China:

Official estimates for growth in China have been in the high 6% range for several quarters. Those numbers will surely fall as the year progresses. Recent business surveys have shown modest upticks, and industrial profit growth has been strong. But, our growth momentum indicator, which summarizes much of the hard production data, has been less than lackluster for months. Domestic demand and investment has been slowing and all such headline indicators were lower in April. Two of President Xi Jinping's goals, reducing pollution and shrinking debt growth, are not growth friendly. GDP growth could easily be in the low 6% range by the end of the year, still a pace about which developed-country leaders can only dream.

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Red-hot U.S. momentum:

Prospects for U.S. growth are surging. Regional Fed surveys of manufacturing companies consistently surprised on the upside in May. Business and consumer confidence indices keep probing near record levels. The job market is outstanding for this late in the cycle. Confidence data tracking the difference between respondents saying jobs are "plentiful" versus "hard-to-get" is the highest of the cycle and the best since March 2001. The May payroll report added another 223,000 jobs with another 15,000 in March and April. Job openings are at records and the jobless rate at 3.8% matched the lowest since 1969. Wage growth is picking up in many metrics.

First-quarter GDP growth was revised down a tick, but from a sizeable step down in inventories, setting up for robust second-quarter growth. Capital spending on equipment was revised higher, giving four straight quarters of a vigorous 9.2% annualized surge each. Investment in structures and intellectual property each rose in low double-digits. Consumer spending in April hit the best pace since November. Housing data has disappointed, but home-builder optimism is high and housing activity stays in a nice uptrend.

More capital spending is a response to incentives from tax reform passed last December, but it's also sorely needed. Investment outside housing and shale oil has been extremely low since 2001, so the capital stock is aging. Robust capital spending bodes well for future growth as its impact multiplies throughout the economy. It should boost productivity, which will bring faster wage growth, higher real incomes, and more consumer spending. Greater output per hour will allow businesses to raise wages without sacrificing profits. U.S. economic growth should average 3% to 3.5% in 2018, and continue with a mild deceleration into 2019.

Conclude:

Growth in the Eurozone, Japan, China, and most of the emerging world won't be as robust as late 2017, but the world expansion will march on into 2019. India is an outlier to the gradual deceleration outside the United States noted above. First-quarter GDP there rose 7.7% over the prior year, outstripping even China. For the U.S. economy, the next few quarters should be even better than the last few.

The path to normal policy

That's what everyone, especially the Federal Reserve (Fed), is trying to figure out. The path includes higher interest rates, but, the question is how high is higher. The long-time consensus that interest rates and inflation would stay "lower for longer" was decimated by the terrific recovery from the near-decade of economic morass in mid-2007 to mid-2016.

Once the synchronized world expansion gathered steam in late 2016, the yield on long-term U.S. treasury bonds had to rise from its historic record low of 1.36% in July 2016. That yield rose smartly after the U.S. election to 2.6% in January last year, but tailed off through the summer. The yield surged again after U.S. tax reform became law in December and hit 3.11% this May. Yields on two-year U.S. treasury bonds rose similarly from 0.55% in July 2016 to a recent high of 2.59%. The fed funds rate (FFR) now is in a range of 1.5% to 1.75% with another 0.25% hike likely at the next Fed meeting on June 14. Recent U.S. rate history is shown in the table below.

Interest Rates

	12/31/2015	12/31/2016	12/29/2017	05/17/2018 (High)*	09/07/2017 (Low)*	06/01/2018 Current
FFR**	0.5%	0.75%	1.5%			1.75%
2-year	1.05%	1.19%	1.88%	2.56%	1.27%	2.47%
10-year	2.27%	2.44%	2.41%	3.11%	2.04%	2.90%
10-2 spread	1.22%	1.25%	0.53%	0.55%	0.77%	0.43%
30-year	3.02%	3.07%	2.74%	3.25%	2.66%	3.05%

*12-month high and low, based on the 10-year Treasury bond over the prior 12 months
**Upper bound on the range of the fed funds rate
Source: Bloomberg

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Long-rates pause; Fed stays gradual:

The path to normal policy and interest rates is likely higher, but, how far. For long-term yields, think about potential nominal U.S. growth, likely about 4% or a bit more. That suggests yields on long-term treasury bonds should also be in that range. If so, it will take a long time to get there. We expect the uptrend in long-term yields to pause here for several reasons. Optimism over growth is surely close to a peak. Non-commercial investors have near-record short positions in long-term treasury bonds, which is a bet that yields will rise more. Finally, if yields rose much further, there would be negative consequences in housing and the stock market. The push for higher yields has exhausted for now.

For the FFR, further hikes depend on inflation and growth. For growth: the U.S. economy is booming; the Atlanta Fed current estimate for second-quarter growth is 4.7%. The jobless rate is 3.8%, surely well below neutral. House prices are surging as mortgage standards ease. All these reasons suggest several more hikes are coming; the consensus is probably for one more each quarter through 2019. That would put the FFR at 2.75% to 3% at midyear 2019, at or above the neutral level.

Inflation:

It's subdued, edging higher, but with no clear breakout. The headline price gauge on personal consumption expenditures (PCE) is right at the Fed's target of 2% over the prior year; the core index (ex food and energy) is 1.8%, both flat for the month. The latter is decelerating when smoothed and annualized over three months. Further, fewer components of the core index are rising than are falling. There are lots of anecdotes about higher input prices and wages, but, they haven't appeared in the indices. Wage growth will surely pick up, but better capital spending should improve productivity, which could keep inflation under wraps.

We think the Fed will stay gradual. The fight against deflation was so tough for so long, the Fed will want to be sure it's over before being too aggressive. Members are also well aware that the Fed has been blamed for creating past recessions by raising the FFR above the yield on long-term bonds, thereby inverting the yield curve. That inversion has occurred shortly before every recession since 1960; several Fed governors have expressed concern about recent yield curve flattening. So, we'll stick with a slow rise in the FFR: two more hikes in 2018 and two in 2019 with perhaps even a pause from potential stock market turbulence early next year as earnings don't match the current soaring optimism. As a result, our forecast for future yields may seem subdued given the economic vigor around the world. Eighteen months is a lifetime in politics as well as markets. Our current thoughts are in the chart 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	0.25%-0.5%	0.0%-0.5%

May asset allocation: Time for a rally?

Likely so. For what was a volatile and seemingly ugly month for markets, returns for investors in U.S. stocks and bonds were mostly positive, especially in small cap and technology. The Russell 2000 Index and the S&P technology sector jumped 6.0% and 7.1% in May, respectively. The S&P 500 Index was up 2.2% in May and is now up for the year, 1.2%. Both the NASDAQ Composite and the Russell 2000 ended May very near all-time highs. Broad indices in Europe, Japan, and emerging markets didn't fare as well; the MSCI Emerging Market Index dropped 3.2% in May and 4.3% for the quarter to date. The MSCI Europe Index lost 4% for the month. Long-term U.S. yields fell a bit during the month, so Barclay's long-maturity U.S. treasury index returned a positive 2.1%.

The outlook:

We think the odds favor the correction to be over and some sort of rally from here. Since the S&P 500 Index correction low on April 2, the Index has moved up in phases of higher highs and higher lows. The cumulative number of stocks that rise in price less the number that fall kept moving higher in spurts throughout the correction and is only a fraction from its all-time high of May 21. Small caps are outperforming. Tech stocks, the leaders since 2009, are leading again. U.S. stock markets have historically been volatile in mid-term election years, but, once the turbulence ends, stocks move higher. All these are good technical signals.

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Economic fundamentals shouldn't hold stocks back either. U.S. profit growth is stupendous and our proprietary Recession Dashboard has no indicator flashing recession. World growth is quite good and the U.S. economy is booming. Outside of emerging markets, financial conditions are not stressful. The Fed will not be aggressive and other developed-country central banks are still accommodative. Inflation is subdued and not likely to spike. The uptrend in long-term rates appears to be arrested. Political risk and trade tensions abound, but the Italian saga has been pushed down the road. Trade problems will continue to simmer, but, perhaps without coming to a boil.

For a trade:

Whatever rally that comes, if it does, is not for the long term. Stock markets may stumble if earnings disappoint later this year or early next. Higher wages and credit costs will cut into profits at some point. Expectations for future earnings are very high and unlikely to come to fruition. U.S. and world growth will decelerate mildly into 2019. For the intermediate term, we still like U.S. stocks with Japanese stocks a distant second. The Eurozone will stay vulnerable to political problems. Emerging market indices will not appreciate decelerating growth, a peak in commodity prices, higher U.S. interest rates, and a U.S. dollar that refuses to roll over like the consensus believed earlier this year. If long-maturity yields stay in a range, real estate investment trusts may continue to gain as they did in May; their valuations were really beaten down. We'd also stick to better quality bonds as higher yields will generate some credit risk as the year wears on.

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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	**17,379.7**	**2.2%**	**17,532.0**	**3.6%**	**17,673.1**	**3.3%**	**17,819.0**	**3.3%**	**16,716.2**	**1.5%**	**17,096.2**	**2.3%**
Personal Consumption Expenditures	**12,065.9**	**1.0%**	**12,168.1**	**3.4%**	**12,254.8**	**2.9%**	**12,342.1**	**2.9%**	**11,572.1**	**2.7%**	**11,890.7**	**2.8%**
Durable Goods	1,757.2	-2.6%	1,774.5	4.0%	1,792.0	4.0%	1,809.6	4.0%	1,595.1	5.5%	1,701.6	6.7%
Non-Durables	2,614.8	0.4%	2,634.1	3.0%	2,656.9	3.5%	2,679.8	3.5%	2,514.3	2.8%	2,575.0	2.4%
Services	7,764.3	1.8%	7,809.5	2.4%	7,856.0	2.4%	7,902.7	2.4%	7,507.3	2.3%	7,675.2	2.2%
Gross Private Domestic Invest.	**3,064.1**	**7.2%**	**3,112.1**	**6.4%**	**3,161.0**	**6.4%**	**3,214.1**	**6.9%**	**2,858.3**	**-1.6%**	**2,952.3**	**3.3%**
Bus. Fixed Invest.	2,418.2	9.2%	2,453.7	6.0%	2,491.6	6.3%	2,530.1	6.3%	2,210.4	-0.6%	2,314.2	4.7%
Structures	490.7	14.2%	495.5	4.0%	502.8	6.0%	510.2	6.0%	446.4	-4.1%	471.5	5.6%
Equipment	1,156.2	5.5%	1,178.7	8.0%	1,201.6	8.0%	1,224.9	8.0%	1,047.8	-3.4%	1,098.1	4.8%
Intellectual Property Products	776.2	10.9%	783.9	4.0%	791.6	4.0%	799.4	4.0%	720.4	6.3%	748.8	3.9%
Residential Invest.	601.9	-2.0%	607.8	4.0%	613.8	4.0%	618.4	3.0%	587.4	5.5%	597.9	1.8%
Change in Inventory	20.2	-	25.0	-	30.0	-	40.0	-	33.4	-	15.2	-
Net Exports	**-650.9**	**-**	**-658.7**	**-**	**-662.7**	**-**	**-666.8**	**-**	**-586.2**	**-**	**-621.8**	**-**
Exports	2,252.9	4.2%	2,270.1	3.1%	2,286.4	2.9%	2,300.6	2.5%	2,120.1	-0.3%	2,191.4	3.4%
Imports	2,903.8	2.8%	2,928.9	3.5%	2,949.1	2.8%	2,967.4	2.5%	2,706.3	1.3%	2,813.2	4.0%
Gov't Purchases of Goods & Services	**2,929.8**	**1.1%**	**2,939.5**	**1.3%**	**2,949.1**	**1.3%**	**2,958.7**	**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%	1,139.7	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	1,797.0	0.8%	1,803.7	1.5%	1,810.4	1.5%	1,817.2	1.5%	1,783.6	1.2%	1,785.0	0.1%
Final Sales of Dom. Product	17,339.2	2.0%	17,488.5	3.5%	17,624.6	3.1%	17,760.5	3.1%	16,664.1	1.9%	17,062.0	2.4%
Final Sales to Dom. Purchasers	17,985.0	1.9%	18,146.1	3.6%	18,286.2	3.1%	18,426.1	3.1%	17,250.3	2.1%	17,681.2	2.5%
y/y	2.8%		2.9%		3.0%		3.1%					

	1st Quarter 19 Forecast		2nd Quarter 19 Forecast		3rd Quarter 19 Forecast		4th Quarter 19 Forecast		2018 Forecast		2019 Forecast	
Real GDP	**17,963.6**	**3.3%**	**18,098.8**	**3.0%**	**18,219.0**	**2.7%**	**18,326.2**	**2.4%**	**17,601.0**	**3.0%**	**18,151.9**	**3.1%**
Personal Consumption Expenditures	**12,430.1**	**2.9%**	**12,522.0**	**3.0%**	**12,604.2**	**2.7%**	**12,680.3**	**2.4%**	**12,207.7**	**2.7%**	**12,559.1**	**2.9%**
Durable Goods	1,827.5	4.0%	1,845.5	4.0%	1,859.2	3.0%	1,872.9	3.0%	1,783.3	4.8%	1,851.3	3.8%
Non-Durables	2,703.0	3.5%	2,729.6	4.0%	2,756.5	4.0%	2,777.0	3.0%	2,646.4	2.8%	2,741.5	3.6%
Services	7,949.7	2.4%	7,996.9	2.4%	8,038.6	2.1%	8,080.5	2.1%	7,833.1	2.1%	8,016.4	2.3%
Gross Private Domestic Invest.	**3,267.4**	**6.8%**	**3,304.0**	**4.6%**	**3,334.9**	**3.8%**	**3,356.8**	**2.6%**	**3,137.8**	**6.3%**	**3,315.8**	**5.7%**
Bus. Fixed Invest.	2,574.3	7.2%	2,606.3	5.1%	2,632.6	4.1%	2,654.7	3.4%	2,473.4	6.9%	2,617.0	5.8%
Structures	518.9	7.0%	526.5	6.0%	534.2	6.0%	540.7	5.0%	499.8	6.0%	530.1	6.1%
Equipment	1,248.7	8.0%	1,267.1	6.0%	1,279.5	4.0%	1,289.0	3.0%	1,190.4	8.4%	1,271.1	6.8%
Intellectual Property Products	811.1	6.0%	817.1	3.0%	823.2	3.0%	829.3	3.0%	787.8	5.2%	820.2	4.1%
Residential Invest.	627.5	6.0%	632.1	3.0%	636.8	3.0%	641.5	3.0%	610.5	2.1%	634.5	3.9%
Change in Inventory	40.0	-	40.0	-	40.0	-	35.0	-	28.8	-	38.8	-
Net Exports	**-671.8**	**-**	**-674.7**	**-**	**-677.3**	**-**	**-677.8**	**-**	**-659.8**	**-**	**-675.4**	**-**
Exports	2,317.7	3.0%	2,335.4	3.1%	2,352.2	2.9%	2,366.7	2.5%	2,277.5	3.9%	2,343.0	2.9%
Imports	2,989.4	3.0%	3,010.1	2.8%	3,029.5	2.6%	3,044.5	2.0%	2,937.3	4.4%	3,018.4	2.8%
Gov't Purchases of Goods & Services	**2,966.9**	**1.1%**	**2,976.5**	**1.3%**	**2,986.2**	**1.3%**	**2,995.9**	**1.3%**	**2,944.3**	**1.4%**	**2,981.4**	**1.3%**
Federal	1,143.4	1.3%	1,146.2	1.0%	1,149.1	1.0%	1,151.9	1.0%	1,135.4	1.7%	1,147.6	1.1%
National Defense	690.0	1.5%	691.7	1.0%	693.4	1.0%	695.2	1.0%	684.9	2.4%	692.6	1.1%
Non-Defense	452.8	1.0%	453.9	1.0%	455.0	1.0%	456.2	1.0%	450.0	0.6%	454.5	1.0%
State & Local	1,821.7	1.0%	1,828.5	1.5%	1,835.3	1.5%	1,842.2	1.5%	1,807.1	1.2%	1,831.9	1.4%
Final Sales of Dom. Product	17,905.0	3.3%	18,040.2	3.1%	18,160.5	2.7%	18,272.7	2.5%	17,553.2	2.9%	18,094.6	3.1%
Final Sales to Dom. Purchasers	18,575.6	3.3%	18,713.8	3.0%	18,836.7	2.7%	18,949.4	2.4%	18,210.9	3.0%	18,768.9	3.1%
y/y	3.4%		3.2%		3.1%		2.8%					

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

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