ECONOMIC INSIGHTS

Principal Global Investors

BY BOB BAUR, ROBIN ANDERSON, AND THE ECONOMIC COMMITTEE

WEEK OF FEBRUARY 1 - 5, 2016

WEEKLY HEADLINES

U.S. OVERVIEW, THE EXPANSION MATURES

This expansion is nearly seven years old. They don't die of old age, but, this one shows clear signs of aging.

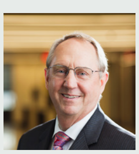
THE LABOR MARKET SUGGESTS THE FED WAS RIGHT

Job growth was below market expectations but the household survey showed the labor market is quickly absorbing excess slack.

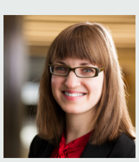
FROM DIVERGENCE TO CONVERGENCE

Central bank policies are converging once again as volatile markets worry those in a tightening mode.

MEET THE AUTHORS



Robert F. Baur, Ph.D.
Chief Global Economist



Robin Anderson, Ph.D.
Senior Global Economist

U.S. OVERVIEW, THE EXPANSION MATURES

The U.S. expansion is now almost 80 months old; only three expansions since World War II have lasted longer. Expansions don't die of old age, but, there are clear signs that this cycle is getting long in the tooth. Business balance sheets are worsening. Bank Credit Analyst calculations show total corporate debt to assets at its 2000 peak. Credit market debt to equity troughed in 2014 and is now increasing. The Senior Loan Officer Survey showed banks are tightening lending standards for commercial, industrial, and commercial real-estate loans.

Falling Profits...

Unit labor costs are trending higher. The initial estimate of fourth-quarter unit labor costs was up 4.5% on a quarter-over-quarter annualized basis. Higher labor costs are not being offset by increased productivity growth. Output per hour grew only 0.6% last year and has averaged a dismal 1.2% pace since 2007, well below the long-term average of 2.1% (from 1947 to 2015). Profits are declining and without rising productivity, higher labor costs eat into margins. Corporate profits in the National Income and Product Accounts were down year-over-year in the second and third quarters of 2015. With weaker than expected fourth-quarter productivity, JP Morgan forecasts that corporate profits dropped 10% year-over-year in the fourth quarter.

Survey measures of company activity are weakening. Given the continued strength in the dollar and weakness in oil prices, it was no surprise that the ISM manufacturing index was below 50 for another month in January. However, the ISM services index dropped sharply to 53.5, a level not seen since 2014.

A Lead to Layoffs:

There is mounting evidence of companies cutting workers to ease margin pressure. Challenger layoffs increased by 41.6% year-over-year in January, a six-month high. The retail sector cut 22,246 jobs, the most in seven years; Wal-Mart expects to slash 16,000 jobs and Macy's 4,820. The energy sector announced 20,246 layoffs; according to CNBC, that's the highest monthly total since oil prices started falling in 2014. Jobless claims remain very low, at 285,000, but are up from their cyclical trough of 255,000.

Does Mature Mean Recession?

We don't think so yet, although the path that leads to one is becoming clearer. Most of the symptoms result from the vicious plunge in oil prices combined with a surge in the U.S. dollar. The fall in profits is due to the collapse of commodity sector earnings. Weak U.S. growth late last year largely stemmed from cuts in capital spending by energy companies and an inventory overhang related to the soaring dollar. Tighter lending standards and wider credit spreads ensue from default prospects and credit problems of energy companies. The weakness in business surveys is surely tied to the surge in the dollar.

But, the dollar and commodity prices are stabilizing; last year's trends are exhausted. So, the credit problems and pressure on those sectors should peak and allow profits and growth to recover as 2016 progresses.

This narrowly-based sectoral weakness in the past has not usually turned into recession. The plunge in oil prices in both 1986 and 1998, while generating significant localized problems, likely extended the expansions rather than ending them. According to Credit Suisse research, eight of 23 subcomponents of U.S. industrial output contracted in the last year. In recessions, typically the vast majority of sectors are declining. Further, manufacturing output, which accounts for 75% of industrial production, is still growing. The Philadelphia Fed's State Leading Indicators show 42 states in expansion, far too many for an imminent recession. The Conference Board's leading and coincident indicators are still rising.

Good Consumer Fundamentals:

Household balance sheets look great and debt service as a share of personal income remains at historic lows. There's plenty of pent-up demand for housing and house prices are rising. Lending standards for mortgages and consumer loans are easing. Workers are enjoying a mild pickup in wages, but, the real treat is much improved real income from lower energy prices. Consumer spending and residential construction should add enough to GDP to more than offset cuts in capital spending early this year.

But, Sentiment is Critical:

The key risks now are a downshift in confidence and a lack of stabilization in credit markets. If businesses see stock prices plunge, decide to rein in costs and layoffs swell, corporate-sector weakness would spread to households. If households become unnerved by gloomy forecasts and volatility in financial markets, even robust real income gains might not be able to keep confidence and spending up. If banks, worried about losses broadening beyond energy and raise lending standards generally, business gets less credit. Good fundamentals can be eroded by dismal market action; perception becomes reality if grim markets create a new, more depressing future. Recession is not our base case for this year, but risks are rising.

THE LABOR MARKET SUGGESTS THE FED WAS RIGHT

U.S. January payrolls disappointed a bit at 151,000 versus 190,000 expected. Jobs in December and November were revised down a net 2,000. With weaker January numbers, the trend in job growth slowed with the three-month average down to 229,000 from 278,000 in December.

Wonky Establishment Survey:

Some of the job growth by sector was just weird. Retail sales added 58,000 jobs after losing 1,000 in December and may be simply difficult seasonal adjustment. Manufacturing added 29,000 jobs, which doesn't fit with weakness in other indicators. Temporary and private educational services were the biggest job losers losing 25,000 and 39,000 jobs, respectively. The decline in temp jobs may be negative for future job growth.

Clear Signs of Labor Market Tightening:

At 4.9%, the unemployment rate finally dropped below 5%, the first time in eight years. The unemployment rate is within millimeters of the Congressional Budget Office's estimate of the natural rate of unemployment, 4.85%. The drop in joblessness came as employment increased. Employment in the household survey, after accounting for changes in population controls, was up 409,000. The labor force participation rate rose a tenth to 62.7%, the third gain in four months; the employment to population ratio increased from 59.5 to 59.6%. The broadest measure of unemployment, U-6, which includes discouraged workers and workers part-time for economic reasons, held constant at 9.9%.

Average hourly earnings trended upward, up 2.5% year-over-year compared to 2.2% last January. Some of that increase may be related to higher minimum wages in 14 states. Still, for December and January, wages jumped 2.9%! Hours worked increased for the first time since August, up to 34.6.

Rate Hikes:

The market had likely pulled its expectation of Federal Reserve (Fed) action back too far. Before the payroll report, market-based probabilities of the next Fed rate rise dropped significantly as investors worried about U.S. growth. But, January jobs clearly showed the labor market is tightening. So, markets capitulated, raising odds of a rate hike this year. We agree; if the jobless rate drops more and wages rise further, that will be enough for the Fed to hike rates in June, all else equal.

FROM DIVERGENCE TO CONVERGENCE

Think central banks. As 2015 ended, investors had to contend with two divergent monetary policy paths: an active, ultra-accommodative one by the Bank of Japan (BOJ) and the European Central Bank (ECB); the other, monetary transition by the Fed and potential shift by the Bank of England (BOE). Those contrary paths were supposed to drive financial markets for much of 2016. But, the difference melted away as an incredibly volatile January triggered fear and worry about deflationary pressures facing world economies. The severe correction in financial markets suggests that policy may become more synchronized until inflation expectations and growth momentum is restored. Clearly, it is the Fed and the BOE that are moving to an accommodative stance more aligned with investor views. Markets offer only 10% odds of a March rate hike and only 55% for one by yearend. The weak fourth-quarter U.S. GDP number seemed to be the catalyst.

From ZIRP to NIRP:

The first to capitulate was the Fed by taking no action in January and muting its economic assessment, saying only that it was "closely monitoring" financial developments. The same week ECB President Draghi virtually pledged more ease in

March to bring inflation closer to goal. The BOJ took the most dramatic action by announcing a negative interest rate of -0.1% to apply to certain bank balances. Last, the BOE Monetary Policy Committee signaled that any rate hike would be a long way off. BOE Governor Carney reduced the inflation forecast and noted that the United Kingdom “cannot help but be affected by an unforgiving global environment and sustained financial market turbulence.” So, everyone is either adding more stimulus or slowing the pace of tightening; it’s policy convergence to respond to a common enemy: slow growth and deflation. It’s the new normal: forever low, always easy.

Much Lower Rates:

This momentary monetary confluence certainly forced rates down around the world. In Japan, the 10-year government bond yields a record low 0.017%, while two-year yields are a negative -0.2%. 10-year yields on German Bunds are off 0.33% from yearend to 0.29%. Germany, France, Demark, Sweden, Spain, Italy, Switzerland, and others in the euro area all have two-year yields below zero; 10-year Swiss bonds yield -0.3%. Japan now has a time deposit rate of zero for consumers. Consumer inflation expectations are just under 1%, so the real yield on cash savings is negative. If BOJ actions succeed in raising inflation prospects a bit more, perhaps some of consumers’ massive cash savings will be spent. That would be the stimulus Prime Minister Abe and the BOJ are seeking.

DISCLOSURES

The information in this document has been derived from sources believed to be accurate as of February 2016. 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 License No. 225385), which is regulated by the Australian Securities and Investment 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 organization. This document is intended for sophisticated institutional and professional investors only.
- Japan by Principal Global Investors (Japan) Ltd. (Kanto Local Finance Bureau (Kinsho) No. 462, Japan Investment Advisers Association; Membership No. 011-01627).
- In the United Kingdom this presentation 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 who are not authorised and regulated by the FCA. In any such case, the client may not benefit from all the protections afforded by the rules and regulations enacted under the Financial Services and Markets Act 2000.
- India by Principal Pnb Asset Management Company Private Limited (PPAMC). PPAMC offers only the units of the schemes of Principal Mutual Fund, a mutual fund registered with SEBI.

This material is not intended for distribution to, or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Insurance products and plan administrative services are provided by Principal Life Insurance Company. Principal Funds are distributed by Principal Funds Distributor, Inc. Securities are offered through Princor Financial Services Corporation, 800-547-7754, Member SIPC and/or independent broker/dealers. Securities sold by a Princor Registered Representative are offered through Princor. Principal Funds Distributor, Princor, and Principal Life are members of the Principal Financial GroupR, Des Moines, IA 50392.

t160209025q

MM8299-06