Principal Global **Perspectives**

2019 outlook | Macro challenges and investment opportunities

The new year brings new challenges and new opportunities for investors. The investment professionals of Principal Global Investors look at the regional macroeconomic outlooks and examine the major asset classes.

The US economy in 2019: Moderating mildly from red-hot

Bob Baur, chief global economist, Principal Global Investors

After two quarters of 4% growth, the US economy is off its peak gains. Still, entering 2019, the jobs market is red-hot. With robust job gains and accelerating wages, average hourly earnings should hit 3.5% by mid-next year. And with another million or more workers to move off the sidelines and into the workforce, there's still slack left in the labor market.

Consumer confidence is near a record level, which should keep consumption at or above 3% for several more quarters in 2019. Capital spending was weak in the third quarter, but with aging capital stock and investment incentives in last year's tax reform, I see US capital spending remaining vigorous.

A prolonged investment cycle should push productivity gains back to 2%, increasing potential growth. This should keep inflation in check, allowing faster real wage growth, which would bolster consumer spending. Gross domestic product (GDP) should see 3% gains through mid-2019 and mild deceleration the second half. With robust wage gains and slim evidence of imminent recession, this economic expansion is poised to be the longest in US history.

Economic growth is vastly improved, so the Federal Reserve (Fed) is normalizing its monetary policy, raising rates, and withdrawing liquidity. The easy monetary policy of the last decade helped propel the stock market, but it's effect is fading, one cause of the volatility and poor returns in 2018. Pundits pointed to trade or geopolitics, but, I don't believe they were the real market movers. Trade makes headlines, but liquidity makes markets.

Unfortunately, this process of policy normalization will quicken in 2019. The Fed will likely raise the fed funds rate in December. Another hike may come in March, but that's not certain. Long-term government bond yields should move somewhat higher, further tightening financial conditions.

It's likely that stock and bond markets are in turmoil precisely because growth has been so robust. Will financial market struggles cause economic growth to stumble next year? It's possible. And there are risks. US-China trade issues and the US budget deficit to

Let’s get the big topic out of the way: I see a resolution of Brexit uncertainty being a big factor for the UK, but not for Europe.

Seema Shah | senior global investment strategist at Principal Global Investors

name just a couple. Still, the underlying fundamentals are mostly healthy, while signs of recession are few. Expect the tumult in financial markets to persist even as growth remains healthy.

One last thought. Passive investing became very popular as investors rode the long stock market rally higher for years. The long bull market in bonds from 1981 ended in July 2016 and the end of the stock market surge from 2009 is likely near. Long, stable trends will likely be few and far between in 2019.

Active investors may need a stopwatch for good timing. For most, it’s a time to be cautious.

European outlook: Way more than just Brexit

Seema Shah, senior global investment strategist, Principal Global Investors

Let’s get the big topic out of the way: I see a resolution of Brexit uncertainty being a big factor for the UK, but not for Europe. Within the UK, my primary concern is the risk that a Labour government led by Jeremy Corbyn could bring. Corbyn’s nationalistic tendencies and calls for a maximum wage law could spell trouble for financial names in the UK.

Moving to broader Europe, the continuation of the Italian saga plays a big role in my 2019 outlook. Italy is attempting a balancing act to appease both Italians and the European powers. Italy’s deputy prime minister Matteo Salvini recently said he’s willing to negotiate on budget, but only on the margins. Unfortunately, Italy’s economic issues don’t lie in the margins.

Investors could expect this low-grade tension with Italy to extend perhaps into the second quarter of 2019. At some point, the European Commission will have to begin disciplinary procedures toward Italy, but not until the budget has been implemented and the Italian deficit is outside the boundaries Europe has set.

How does the Italian drama play out? One possibility: Salvini steps down, potentially forced by market discipline if sovereign yields shoot up so much that the government has no choice but to rein itself back in. Another possibility is an internal recalculation where Italians come to understand that the budget numbers don’t add up and that a less anti-Europe attitude is the way forward. While this story searches for its ending, expect continued volatility in European markets.

I’m also watching for who the European Central Bank (ECB) picks to take over for its current president Mario Draghi. I expect economic headwinds from a more hawkish and less market friendly successor. If that comes to pass, at some point in 2019, markets will start to reprice interest rate expectations for 2020 and begin contemplating whether the ECB starts reducing its balance sheet ahead of expectations.

Also watch how the ECB handles their long-term refinancing operation (LTRO) scheme that’s been in place since 2011. New banking regulations from Basel stipulate that these LTRO funds cannot be allocated to their capital requirements. If the ECB decides to issue a new LTRO, it could deal with the new Basel regulations and address some liquidity concerns. In that scenario, investors could expect some relief of banking stress, particularly within Italy.

Asia outlook: 3 key events to watch in 2019

Binay Chandgothia, managing director – portfolio manager and head of Asia, Principal Portfolio Strategies

Global trade, the Federal Reserve's path to normalization, and oil prices are three key factors affecting my thoughts for Asia in 2019.

The global trade outlook has a direct bearing on Asian growth, given the significant linkages built over the years through integrated supply chains. This cycle is linked not just to trade within the region, but also to trade with the developed markets, the US in particular. A breakthrough in talks between the US and China that leads to a deal and reduces the uncertainty hanging over markets would be a welcome development in the coming year — and we may be seeing the initial stages already.

Another important macroeconomic event with a significant impact on Asia is the extent to which the US Federal Reserve induces a global tightening in financial conditions. Asian central banks often interpret interest rate increases as signals, pushing them to realign rates higher if their economies are solid. The other aspect is the dependence of many Asian economies on global financial flows. These flows tend to ebb or even reverse if interest rate differentials between Asia and the US become too narrow. Thus, Asian economies are forced to adjust their rates higher for macroeconomic stability, even if their domestic growth and/or inflation rates don't require such actions.

The third important trend to watch is high oil prices, which act as a drag on both the Asian consumption and outsourcing stories. They amp up the current account funding and inflationary pressures, necessitating growth-reducing steps like interest rate increases. They also reduce dollar liquidity in markets, so lower oil prices should help most of the region.

Investors should be nimble and be ready to allocate back to some of the Asian markets that didn't do well in 2018. This would include equity markets in Hong Kong, offshore China, Singapore, and South Korea, which are all trading extremely cheap relative to history. India, Philippines, and Indonesia could also be interesting because their currencies came under pressure during the year from a combination of higher US rates, high oil prices, and evaporating investment flows.

My base scenario is that the US-China trade dispute starts getting sorted out in 2019; however, given that it could go either way, investors should probably maintain a balanced, diversified approach to avoid pronounced idiosyncratic risks.

Political change in Latin America could determine economic progress

Valentin Carril, chief economist & strategic allocation head of Latin America, Principal

The economic stories to pay attention to in Latin America in 2019 are Brazil and Mexico.

Brazil is hoping for economic improvement, but the likelihood of that improvement depends primarily on recent political changes. Jair Bolsonaro, set to begin his 4-year term on 1 January, will need to tackle the mounting debt load in Brazil, where the debt-to-GDP ratio has recently been around 75%. The other issue to address is the country's large and messy pension system.

To begin solving both, privatization plays a key role. First, the government should sell some assets through privatization and reduce Brazil's debt by about 20%. This would hopefully lead to a positive feedback loop, where lower debt implies lower risk. Lower risk then lowers the yield spread, which makes debt payments more sustainable. The question is whether the government will sell the assets that can raise the needed capital.

As with Brazil's debt issues, privatization has a role in reforming Brazil's national pension system, too. A combined system of public and private solutions could be more stable and lessen the burden on the government. For investors, I see a binary outcome. Either Bolsonaro can create meaningful change, or not. In the former scenario, I see most types of Brazilian assets doing well. In the latter, Brazil will struggle.

I have a benign view of Mexico going into 2019. Despite the twin economic shocks of the Trump presidency in the US and a 10% decline in oil production, Mexico has been growing in line with its peers. In October, the ratings agency Fitch downgraded its outlook for Mexico to "negative" in reaction to president-elect Andrés Manuel López Obrador cancelling plans for a new airport in Mexico City, which heightened concerns about the economic policies of the new government.

So one of the keys for Mexico in 2019 is to regain the market's trust. Since the Mexican economy is in fine shape and inflation is under control, investors should watch these political developments closely. With this in mind, investors in Mexico are best served looking at equity shares in companies that are somewhat more isolated from this political risk.

One other issue I'll be watching closely is the minimum wage. For a long time, Mexico has had a very low minimum wage—and, subsequently, very low unemployment—compared with Latin American peers. López Obrador has talked about doubling the minimum wage. While I think Mexico can stand to increase their minimum wage, a 100% increase seems too extreme for the economy to handle gracefully.

Watch the earnings in equities

Mustafa Sagun, chief investment officer, Principal Global Equities

My overall theme for 2019 equity markets is cautious optimism. I see markets continuing to trend higher, but with volatility. Investors should build downside protection in their equity portfolios and be opportunistic for upside when the market sells off.

The market's transition to more normal levels of volatility with occasional sell-offs will continue. Watch earnings though, because as long as earnings growth expectations are positive, which they are now, equity markets tend to have positive returns. Consensus expectations for earnings growth in the coming year have been recently downgraded from double to single digits. So the change that triggered the sell-off and de-rating of P/E ratios is negative. And yet, I see good valuations in the market since they've already got expectations of slowing earnings growth built in. If earnings growth doesn't deteriorate further, I believe markets will react positively and continue to go up with some multiple expansion.

Two of the biggest risks to my overall theme are the ongoing trade wars and increasing interest rates. Resolution, which we're seeing nascent stages of with a revised NAFTA and a "truce" between the US and China, would be the greatest catalyst for equity markets in 2019.

Trade wars are starting to affect China and the emerging markets in their orbit, as well as the earnings of the large importers and exporters that make up a big part of equity indexes. These companies could see trade-related earnings hit much more than the more domestically oriented mid- and small-cap companies, so my preference is toward the smaller end of the market and away from the emerging markets exposure until we see solid progress towards a resolution of these uncertainties.

And while some market watchers focus on interest rates, yield curve inversion, and recession risks, I don't see an inversion for the next 6 to 12 months. Usually, earnings recessions tend to start up to 12 months after the yield curve has already inverted. If the Fed continues to raise interest rates and the long end of the yield curve doesn't move up, investors will start pricing in true recession risks for 2020 in the second half of 2019. Watch the earnings of consumer-oriented companies; these could serve as a leading indicator to a broader earnings recession, where they have been in the past.

For equity investors, focusing on downside protection means striving to participate when markets are up, but limiting down-market losses. I think one way to accomplish this is to be a stock picker and not blindly follow the capitalization-weighted equity indexes lower just because of their cost advantages. Investors should look for high-quality earnings, but not overpay for that quality. We like less cyclical companies that deliver consistent earnings growth even during recessions because of their competitive advantages. Some technology companies (not the high-growth, high flyers) fit into thesis including certain healthcare and consumer staples companies. Energy is one cyclical area that provides an opportunity right now after the recent sell-off. Stay the course, follow the earnings, and be opportunistic when everybody else panics.

The Fed, fixed income, and a flight of "fallen angels"

Dave Blake, chief investment officer, Principal Global Fixed Income

Among the investment teams across Principal Global Fixed Income, we increasingly believe that the Fed ends its tightening cycle in 2019. That's what guides our outlook for 2019. I'd expect the yield on the 2-year Treasury to peak inside 3%. And I don't see the yield on the 10-year Treasury getting much higher than it is at the beginning of December.

Why? Signs of decelerating US and global growth, trade tensions, signs of stress in emerging markets, and a strong dollar relative to those markets. Credit conditions in the US are tightening, where gross leverage is at a cycle high. Profit margins have likely peaked and will begin to roll over. Plus, markets are starting to get wobbly. When you factor all that together, it adds up to a Fed that will pause in 2019, and that creates opportunities.

For fixed income investors, this could present a good opportunity to very gradually extend durations in the coming year. A lot of money has been socked away in cash, money market funds, and short-duration strategies. I think there's an opportunity for investors to gradually move into the intermediate-duration space over the next year. This will help extend overall duration, capture the term premium of rates, and benefit from a likely elevated risk premium on corporate bonds—more so than what investors have seen in recent years. Hopefully, investors can begin to lock in more attractive yields.

As the Fed-tightening cycle ends, capital that had moved to Europe and Japan could move back towards the US. That will create a bid and an opportunity in credit markets. The team is positive on mortgage-backed securities, where fundamentals are solid and the risk-reward tradeoff is as good as it's been in years. We think that we're currently in the tough part of the cycle, but that as we get to the conclusion, some good things will come.

One of the risks we're watching in credit markets is the potential wave of over-levered BBB-rated corporate bonds falling from investment grade to high yield. This flight of potential "fallen angels" would have a big impact on the high yield market and create disruption. For the companies themselves, borrowing costs could increase quite significantly. Hopefully we get some additional clarity on this situation as it plays out over the next few months. This all makes us a bit more cautious on credit and high yield than we might otherwise be.

Focus on “DIGITAL” drivers in real estate

Indraneel Karlekar, senior managing director of global research and strategy, Principal Real Estate Investors

Themes affecting commercial real estate in 2019

- Expect slower, synchronized global growth to drive varied opportunities in commercial real estate.
- Look for the US growth outperformance with other developed economies to fade toward mid-year as the economy wrestles with tighter monetary policy.
- The variance between US and Eurozone short-term interest rates will likely remain. This could provide a more favorable capital markets backdrop for European real estate opportunities, especially for core strategies.
- Combine tactical and strategic. Short term: Look for areas less reliant on capital market forces and more reliant on income potential. Longer term: Focus on what we call DIGITAL trends (demographics, innovation, globalization, infrastructure themes for active long-term investors).
- Policy and political challenges are center stage. A hawkish Fed raises the risk that perceived policy errors might swiftly feed back to the real economy through a rapid tightening in financial conditions. Geopolitical risk is also a concern.

Demographics, innovation, globalization, and infrastructure themes for active long-term investors (DIGITAL)

These are long-term trends that we believe investors should use as guideposts to identify investment opportunities. We expect these factors to influence and drive tenant demand and investment performance in the years ahead.

Demographics

Significant demographic changes offer many opportunities for real estate investors in the coming years. Each demographic group drives unique real estate investment opportunities, from assisted living for the Silent Generation to coworking office space for Generation Z.

Innovation and technology

Technology has been a significant driver of productivity and consumption. Real estate value creation is increasingly heading to cities with skilled workforces, strong infrastructure, and supportive institutional frameworks.

Globalization

Technology, labor, and capital are the connective pathways of the global economy. And cities are increasingly competing for all three. E-commerce, with its attendant supply chain requirements, is a powerful—and growing—force. High-tech manufacturing will increasingly become globalization’s driving force, with its specialized centers of excellence and globally integrated supply chains.

Preferences

Within core real estate, we see modestly better relative value in the Eurozone. We are less optimistic on the UK, where Brexit challenges are starting to feed through into tenant demand and capital market conditions.

In debt, we believe the US offers some interesting opportunities given the expected lift in the LIBOR curve and the strong demand from an array of borrowers. Core mortgages may finally begin to address some long-term asset liability needs for borrowers. Subordinate lending in the US may also offer more attractive relative value compared to the Eurozone and the UK. We have a clear preference for industrial (e.g., logistics and warehouses) and residential rental assets across all geographies. For public market strategies, we have a near-term bias to the Eurozone and the UK, which offer a more favorable spread to long-term bond yields.

For asset allocation, adjust your mindset, adjust your portfolio

Todd Jablonski, chief investment officer, Principal Portfolio Strategies

The normalizing changes in risk asset markets in 2018 will require a change in investor mindsets in 2019. After nearly ten years of high returns and low volatility, it's high time to reevaluate risk and reassess the direction of your asset allocation.

It starts with recency bias, that human tendency to overemphasize the recent experience as your guide for the future. In this case, investors have been lulled to sleep by the high-return, low-volatility paradigm that's existed since 2009 at the end of the financial crisis. Over the last several years, this has been particularly acute, especially in 2017, where markets achieved historically low levels of volatility while producing well above average returns. I feel that's caused investors to systematically underestimate the level of risk in their portfolios. Unless they correct this, investors may be rudely awakened to find that their expectations have come untethered from current late-cycle realities.

The investment team at Principal Portfolio Strategies believes investors should reduce their return expectations and increase their risk expectations. Global risk-asset returns have far outpaced economic growth and long-term averages in the decade after the global financial crisis. In addition, loose monetary policy has filled the sails of the markets over the past decade. With central banks moving back toward normalization, particularly US interest rates rising, markets will once again have to be supported through strong fundamentals.

Markets have already begun to see a return to more normal levels of volatility; the VIX hasn't dipped below 10 since the first quarter of 2018. To position their portfolios for more normal volatility, I believe investors should return to their strategic asset allocation. This is your base-case, risk-neutral portfolio. I call this point "true north."

As volatility moves up, I see potential downside surprises for correlations among asset classes, a good opportunity for investors to maximize their portfolio efficiency. When asset classes are less correlated, there's more potential benefit from portfolio diversification and more potential value from active management. On the fixed income side of the portfolio, I would focus on interest rate risk and credit risk to inform any changes in investors' volatility-reducing components.

Overall, we believe it's prudent to focus on long-horizon, higher-quality, lower-turnover active managers and let them work.

Find the most efficient ways to get the exposures you need. This may mean finding the right investment vehicle, such as moving from a traditional mutual fund to an actively managed ETF. This search for efficiency may also mean using a different strategy – factor-based investing, for example, or seeking out different asset classes than you've used in the past.

Ultimately, we believe investors should find the appropriate asset classes, determine the most efficient vehicle, then let us help you design a portfolio to address your unique return needs and risk tolerances to achieve your desired outcome.

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