Economic Summary

Morley
Capital Management

At the December meeting, the Federal Open Market Committee (FOMC) voted to raise the federal funds rate by 25 bps to a range of 2.25% to 2.50%, resulting from its increasing comfort that the economy will grow above their target of 2.0%. Gross Domestic Product (GDP) growth appears to be continuing its downward trend, tracking slightly below 3% for the fourth quarter after an expansion of 3.4% in the third quarter, down from the 4.2% in the second quarter. Core inflation is around the Federal Reserve (Fed) target of 2%. On December 19, 2018, U.S. Federal Reserve Chairman Jerome Powell riled the markets by implying the Fed was on target to raise rates multiple times in 2019 along with the balance sheet shrinking. The market responded with a 7.7% drop in the S&P 500 Index over four days. On January 4, Chairman Powell walked back his prior comments and the market reacted by removing expectation of Fed rate increases in 2019 and even priced in the possibility of a cut in rates.

Employment increased by 312,000 jobs in December, though more people entered the labor force, resulting in the unemployment rate increasing 0.2% to 3.9%. The labor force participation rate, the proportion of the population either looking for a job or already with a job, increased by 0.2 % in December, to 63.1%. The unexpectedly strong jobs rate alleviated some fear of an imminent U.S. recession, while equity markets recovered some of their recent losses.

The economy continues a historically long expansion, though there are signs that housing and autos are slowing. Rising prices and lack of affordable supply are slowing the housing market. We believe that the economy can continue to expand if government policies do not experience a misstep. Monetary policy is a concern if the Fed tightens too much and the economy falls into recession. Fed representatives have been vocal about now being patient in raising rates. It appears that the Fed will assess economic data and market conditions rather than continue on its deliberate path of raising rates.

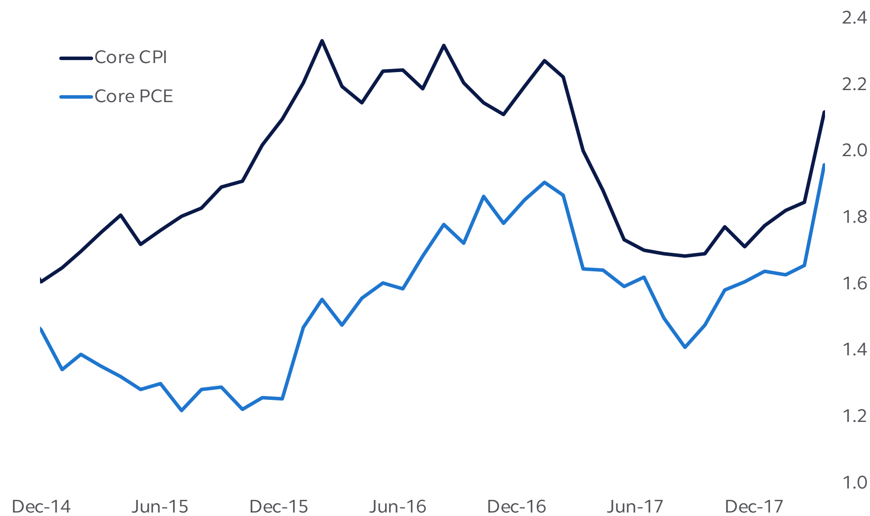
Trade policy is another area of concern. The Trump Administration has made progress with Canada and Mexico, though it faces a more difficult struggle with China. President Trump has indicated that progress is being made which may have pushed the Administration to delay additional tariffs until March 2, while it continues negotiations. We believe it is possible that tariffs are further delayed if progress continues.

Market sentiment has shifted dramatically from October, when equity prices were reaching new highs. The equity market retreated almost 20%, slipping into a bear market as participants started to price in a significant economic slowdown, with the possibility of a recession. Markets tend to overreact in both directions, so sentiment should reverse with the Fed sidelined and a deal with China deal more likely. We expect U.S. economic growth in the 2% to 2.5% range in 2019, and as the Fed reduces its balance sheet we should see a modest increase in interest rates.

Bill Finley, CFA
Portfolio Manager

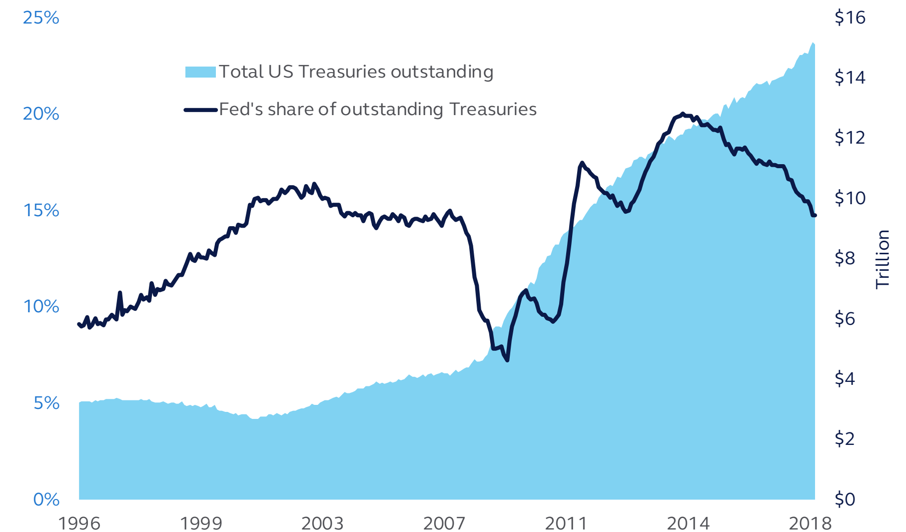
Visit us online at
www.morley.com
for the most recent market updates, Insights and Perspectives

Inflation



Source: U.S. Bureau of Economic Analysis

Outstanding Treasury Holdings



Source: Federal Reserve Bank of St. Louis

Highlights

Core price increases to the consumer, as measured by the Consumer Price Index (excluding food and energy,) have increased at a consistently higher rate than the Core PCE.

While FOMC participants acknowledged at their December meeting that inflation expectations had edged lower, they still view price activity as consistent with their 2% inflation target.

Outlook

We anticipate that there will be some modest upward pressure on these price measures given our expectation for economic growth and strong consumer demand driven by strong employment. Muted expectations in the market for inflation will allow the Fed to pause their interest rate increases.

Highlights

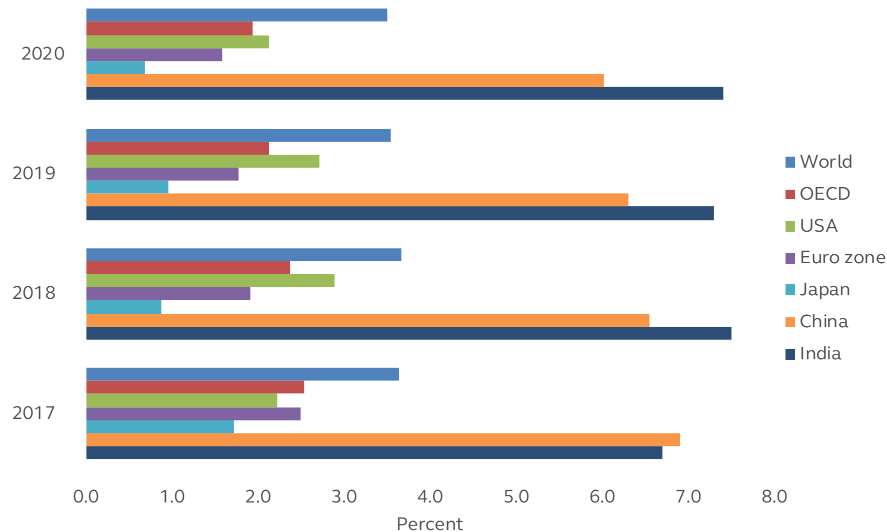
The Fed's share of outstanding U.S. Treasuries increased sharply during the period of quantative easing from March 2009 thru September 2014. During the same period, the amount of total outstanding U.S. Treasury Debt has also risen sharply.

With no end in sight to future U.S. budget deficits, it is likely that the trend of higher outstanding U.S. Treasury debt continues. The ongoing run-off of the Fed's Treasury portfolio as part of the normalization of monetary policy would allow the Fed to keep quantative easing as part of the toolkit should it again be needed.

Outlook

As growth slows and the Fed takes a pause in raising policy rates, tightening continues by way of the Fed's portfolio run-off. Should it turn out that the peak for rate increases is near, the Fed may not have allowed itself ample room to stimulate, when needed, through rates alone and quantitative easing may again be required. The massive increase in outstanding Treasury debt may mean that significantly more asset purchases will be required next time to achieve the Fed's objectives.

Global Growth



Source: Organisation for Economic Co-operation and Development

Highlights

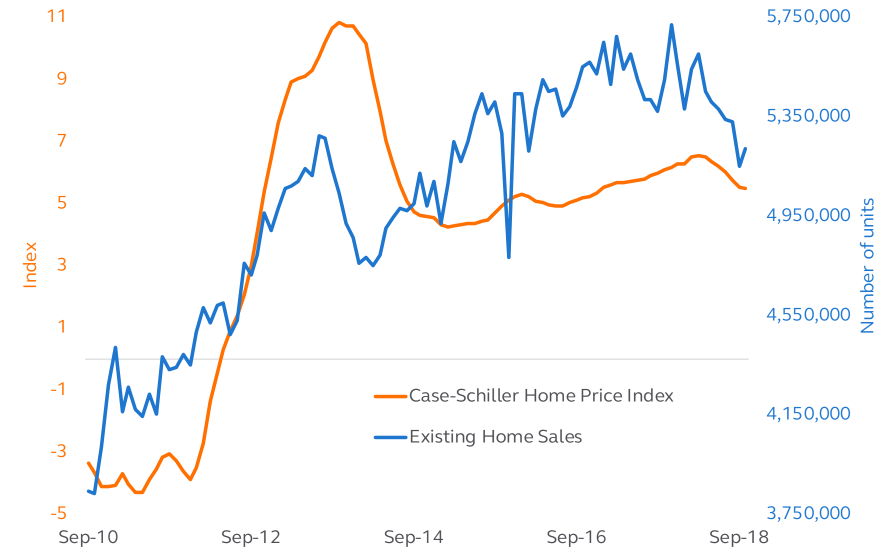
Global growth in 2018 is estimated to have increased slightly to 3.6%. Estimated growth in the U.S. accelerated to 2.9% while growth in the Euro zone, Japan and China weakened.

Growth is expected to slow down in 2019. India and China are once again expected to be the fastest growing economies at 7.25% and 6.30%, respectively, though even those numbers represent deceleration of economic activity.

Outlook

With the outlook for global growth softening, central bank policies are at varying phases of the monetary cycle. The U.S. Fed is well into monetary tightening both by raising policy rates and reducing the balance sheet. The European Central Bank has just begun its exit from quantitative easing, and the Bank of Japan does not seem to be anywhere near its monetary target that would reverse its accomodative stance. Since global inflation remains modest, central banks will likely slow their reversal of easy monetary policy. The U.S. Fed has paused rate increases for now. We expect global growth to slow in the first half of the year, though we do not see a U.S. recession.

Housing



Source: Bloomberg

Highlights

Existing home sales, seen as a barometer of demand for housing, has seen a consistent rise from 2010 to 2017.

The Case-Schiller Home Price Index (HPI) represents the year-over-year national average home price appreciation, and when coupled with home sales, gives an indication of the balance between supply and demand for homes.

The large jump in HPI in begining in 2012 and a 4%-6% year-over-year rise in prices for the five years spanning 2012-2017 indicates that supply of affordable homes has not been able to keep pace with demand. As a result of this, the housing market has softened in 2018 as seen by the dip in home sales and the corresponding deceleration in HPI.

Outlook

Unless interest rates retreat, the soft housing market is expected to continue into 2019. Demand for affordable homes will likely continue to outpace supply which could turn away potential new buyers and give pause to owners looking to trade up. This could lead to further deceleration in the HPI, though its level remains high compared to 2010.

Macroeconomic outlook offering a base case and two tail scenarios.

	Base Case (75%)	Tail 1 (15%)	Tail 2 (10%)
	Modest growth	**Prolonged weakness**	**Inflation / Stronger than expected growth**
	GDP growth forecast for 2018 is 2.90%. Growth slows to 2.5% in 2019.The Trump Administration has fostered a pro-business climate. Reduced regulation and tax cuts are positive drivers for the economy. The $1.3 trillion spending bill provides stimulus, but increases the deficit. Morley's growth estimate of 2.50% is slightly lower than the consensus of 2.60%. Core PCE will stay near the Fed target of 2%. China grows in the 6% range. Europe continues to recover. North Korea is handled through diplomacy. The Fed moderates its language by saying they are data dependent and they move away from increases every quarter. The trade war with China is prolonged and causes volatility, but doesn't lead to a recession. Low global rates make U.S. term rates attractive and mute their rise. Solid growth and inflation will lead to modestly higher interest rates.	The global economy is slowing, with Germany and Japan both reporting negative GDP growth rates in the latest quarter. China is also slowing down. China may be limited in the stimulus it can provide. A slowdown due to the significant debt that has built up in China reverberates throughout the world. The world enters synchronized slower global growth. The Trump administration has given China ninety days to come to a trade agreement. If there is not significant progress the trade war will be escalated. The Fed raises rates too quickly and slows the economy. Market participants and business executives view the Fed hikes as a policy error and retreat from equities and business expansion. The Trump administration becomes bogged down by the investigations launched by House Democrats.	The Fed takes a pause in rate hikes, which relieves the fear that they will induce a recession. There is progress with China on the trade front. China has already agreed to begin purchasing soybeans. The agreement includes some mechanism to penalize the transfer of technology. Chinese growth rebounds as tariffs are removed. The successful renegotiation of a trade deal reduces friction with Canada and Mexico. The U.K. and the EU come to amicable terms on the UK exit. Growth in Japan and Germany rebound as the cause of downturns were due to special events. Consumer confidence and business confidence remain at record levels. The threat of terrorist attacks is reduced and the Middle East problems improve. The North Korean threat is solved peacefully. The drop in the unemployment rate leads to rapid wage growth. The rise in interest rates does not damage the economy.
GDP	2.50% in 2019	Below 1.00%	Greater than 3.75%
Change in Rates	2Yr 2.80%, 10Yr 2.96%	Sharply lower / -125 bps (10Yr UST)	Sharply higher / +100 bps (10Yr UST)
Change in Curve	Curve remains flat 2-10s	Bull flattener	Bear steepener
Volatility	Remains elevated	Higher	Higher

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

The material provides economic and investment commentary that represents the opinions of Morley Capital Management (Morley), a specialized investment boutique of Principal Global Investors, LLC, and such opinions should not be considered investment advice or an evaluation, recommendation, offer, or solicitation of any particular security or strategy. The opinions provided do not take into account the investment objectives, financial situation, or needs of any particular investor and prospective investors should consider whether any security or strategy is suitable for their particular circumstances, carefully consider the risks associated with any security or strategy (including a review of applicable disclosure documents) and, if necessary, seek professional advice before investing.

The material represents information available at the time of production, no forecast based on the opinions expressed can be guaranteed, and such opinions and data may be subject to change without notice. Although the information is obtained from sources deemed to be reliable neither Morley nor its affiliates can guarantee the accuracy of the information.

Investment management services are provided by Morley, a specialized investment boutique of Principal Global Investors, LLC.

Investing involves risk, including possible loss of principal. Fixed-income investments are subject to interest rate risk; as interest rates rise their value will decline. Fixed-income investment options that invest in mortgage securities, such as commercial mortgage-backed securities, are subject to increased risk due to real estate exposure.

Principal Global Investors, LLC (PGI) is registered with the U.S. Commodity Futures Trading Commission (CFTC) as a commodity trading advisor (CTA), a commodity pool operator (CPO) and is a member of the National Futures Association (NFA). PGI advises qualified eligible persons (QEPs) under CFTC Regulation 4.7.

Principal Global Investors leads global asset management at Principal® and includes the asset management operations of the following members of Principal®: Principal Global Investors, LLC; Principal Real Estate Investors, LLC; Principal Real Estate Europe Limited and its affiliates; Principal Enterprise Capital, LLC; Spectrum Asset Management, Inc.; Post Advisory Group, LLC; Columbus Circle Investors; Finisterre Capital, LLP; Origin Asset Management, LLP; Principal Global Investors (Europe) Limited; Principal Global Investors (Singapore) Ltd.; Principal Global Investors (Australia) Ltd.; Principal Global Investors (Japan) Ltd.; Principal Global Investors (Hong Kong) Ltd., and include assets where we provide model portfolios.