Roadmap for the future

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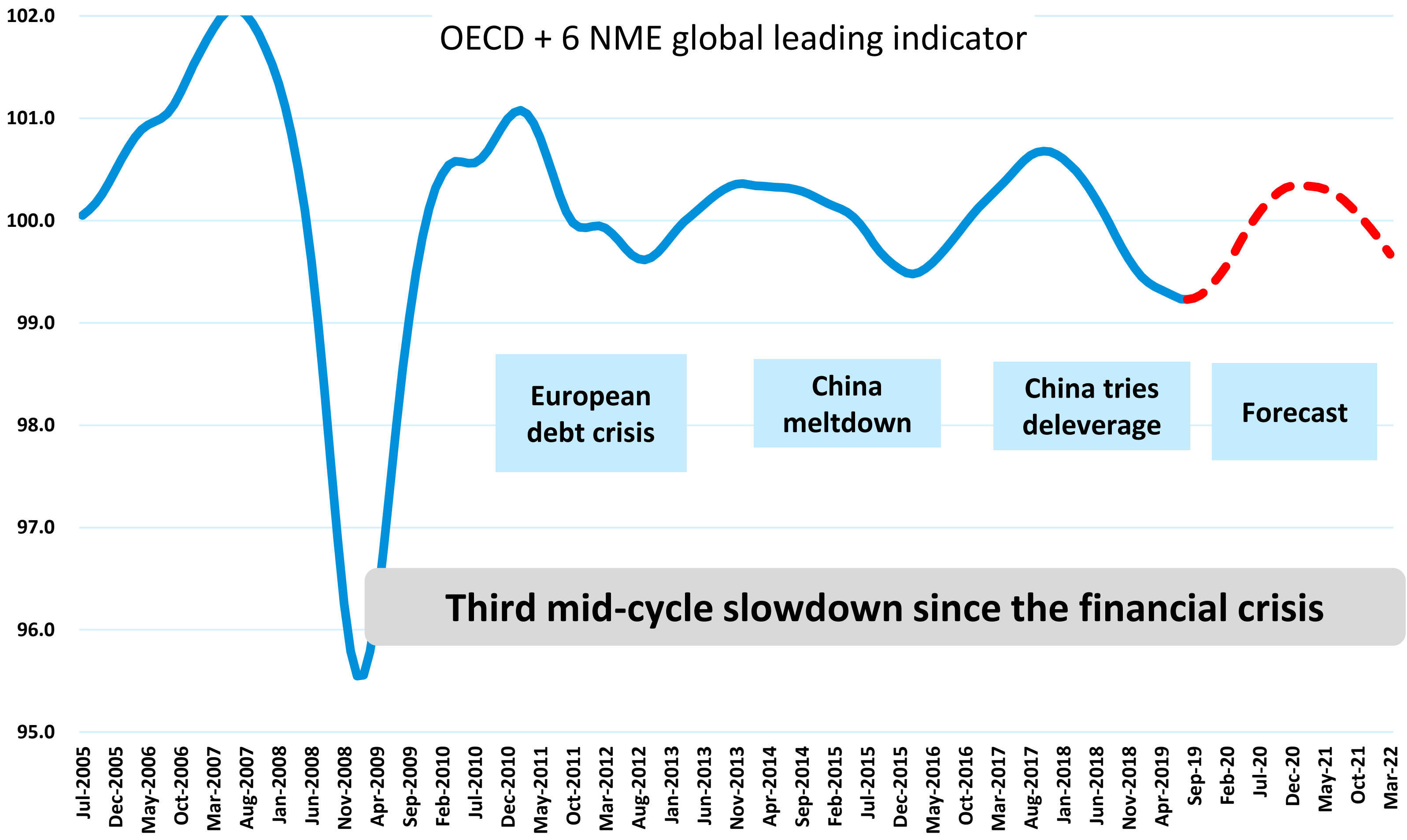
Themes for 2019, beyond

- Main Street prospers; Wall Street struggles
  - World growth should pick up
    - But, could be the final phase of expansion
  - Financial markets struggle
    - End-cycle transition
  - Preview of potential next investment cycle
    - A little more inflation, mildly higher interest rates

I. World slowdown should fade

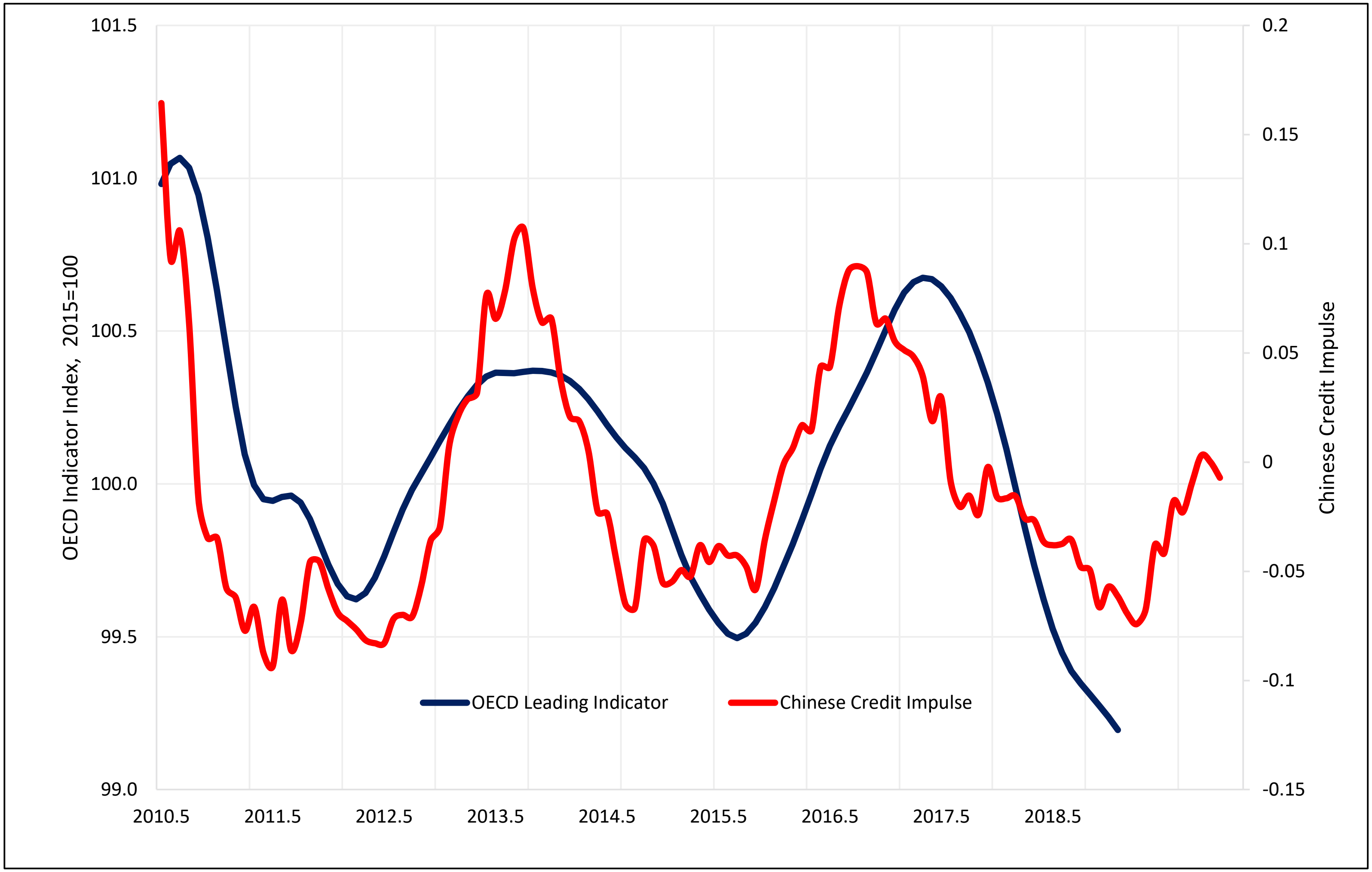
- Global economy still at crossroads
  - But, underlying fundamentals improving
    - U.S., China: better momentum
  - No economic, financial crisis
    - Limited stress in credit markets
    - Continuing China stimulus
    - Central banks accommodative
  - Some green shoots appearing

Growth cycles



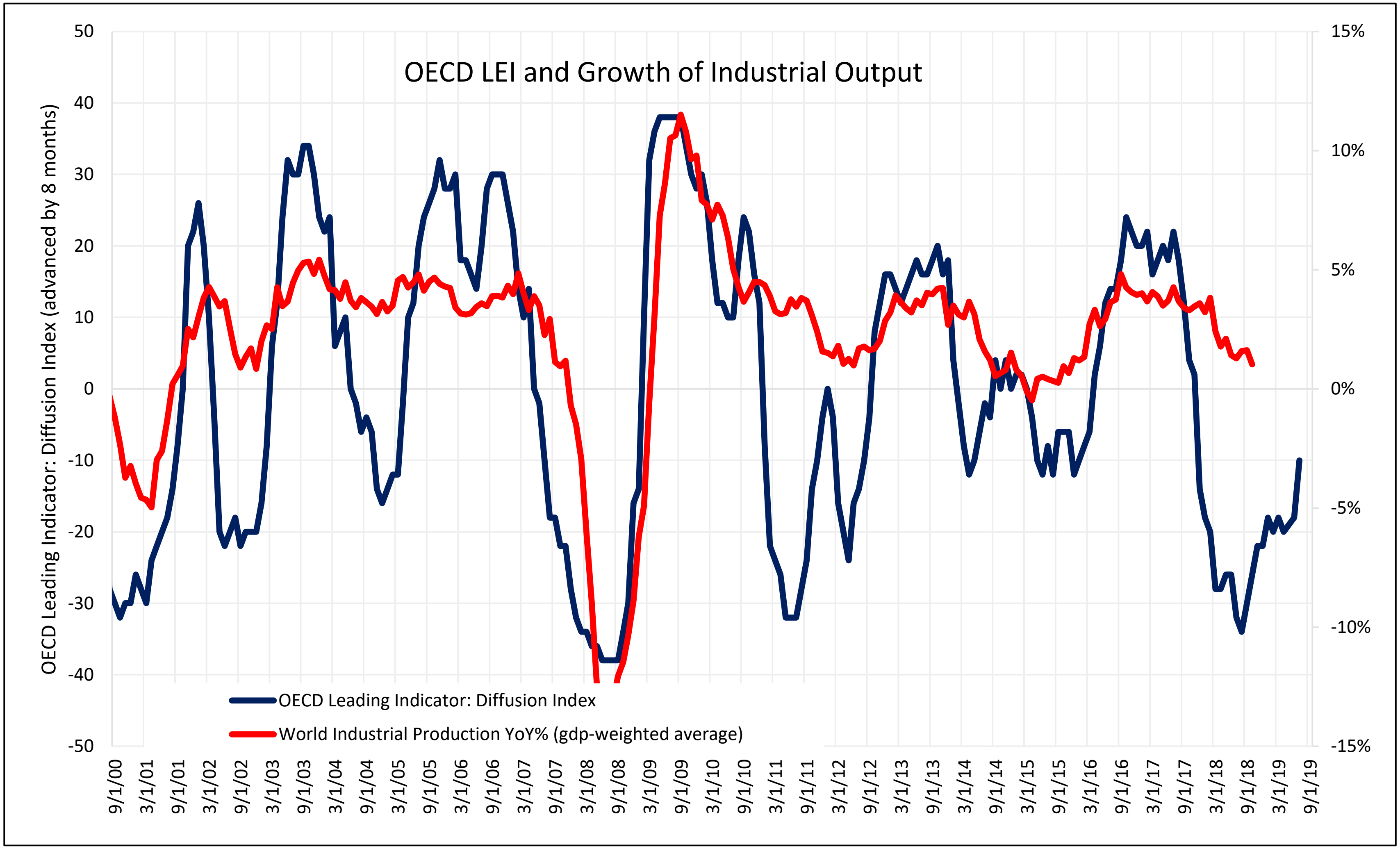
Sources: Organization of Economic Cooperation and Development; Principal Global Investors.

China credit leads



Sources: Organization of Economic Cooperation and Development; Bloomberg; Principal Global Investors.

OECD diffusion index leads



Sources: Organization of Economic Cooperation and Development; U.S. Bureau of Economic Research; Principal Global Investors.

Business cycle winding down

- While growth should improve into 2020…
  – US long-leading indicators say recession out there
    - Inverted yield curve
    - Slowing payroll gains
    - Diminishing profit growth
  – Risks: profits fall from rising wages
    - Credit stress, problems 2021
  – Political risks: U.S. election, China conflict

II. Financial markets struggle

- Long investment cycle likely over
  - But, it was a great ride
    - March 2009 to January 2018
    - Unique economic backdrop
    - Great environment for U.S. assets
    - Love affair with passive management
  - Stocks driven by falling interest rates…
    - Not a surging economy

Strains apparent

- Little net progress for 21 months
  - Past winners failing
    - Valuations peaked January 2018
    - Tech leadership topped June 2018
  - 2019 rally from plunging interest rates: unsustainable
    - Private equity surging: unsustainable
  - Transition: leaders of the new cycle
    - Short, tactical turns only
    - Active management should outperform

What’s an investor to do?

- Be cautious
  - Six- to 12-month outlook
    - No long-term trends
    - Prefer short-term, high quality corporate bonds
    - Modest equity upside into 2020
    - Keep balanced equity portfolio
  - Risks
    - Profitability-driven recession possible 2021
    - Thucydides trap

III. Long-term roadmap

- Possible next cycle
  - A bit more inflation
    - Causes of disinflation fading
      - World growth slowdown
      - Economic slack from financial crisis
      - Globalization
    - Middle class wages: the next bull market
    - Central banks stay accommodative
    - Fewer subsidies to inflation-fighting tech companies
  - Implies somewhat higher interest rates

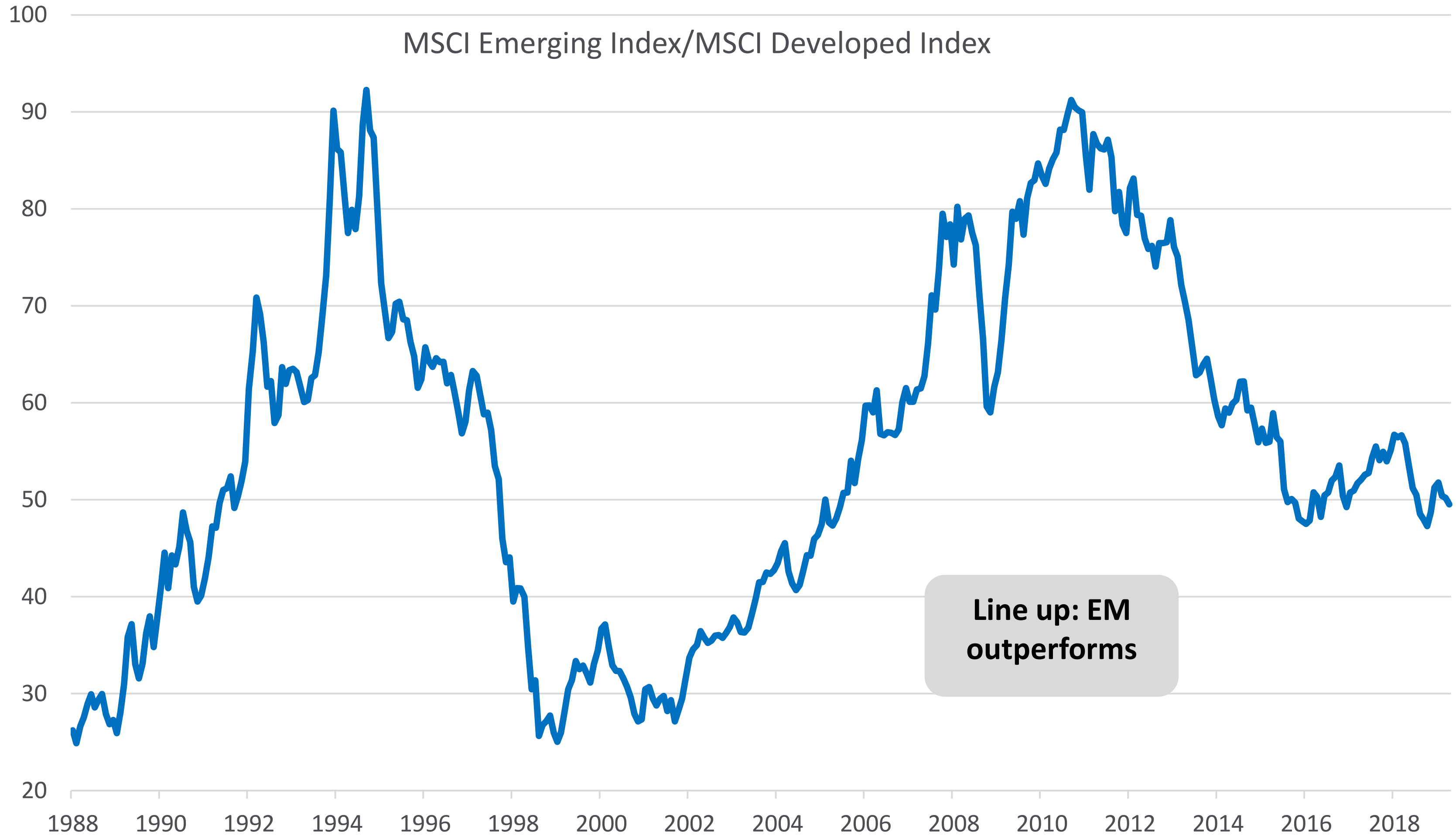
Investing in the next cycle

- Good long-term financial returns: very hard to find
  - Avoid bonds: yields need inflation premium
  - Stock market could stay range-bound
    - Interest rates can't drive markets; globalization profits fade
    - Internal rotation: value over growth; financials over tech
      - International over US; emerging over developed
      - Sterling, euro, yen over US assets
  - Real estate, farmland, commodities, emerging markets
    - Companies owning real assets: energy, mining
  - Active managers outperform
    - Passive investors loose patience

Growth versus value

Sources: Bloomberg; Principal Global Investors.

Emerging versus developed



Sources: Robert Shiller: Bloomberg; Principal Global Investors.

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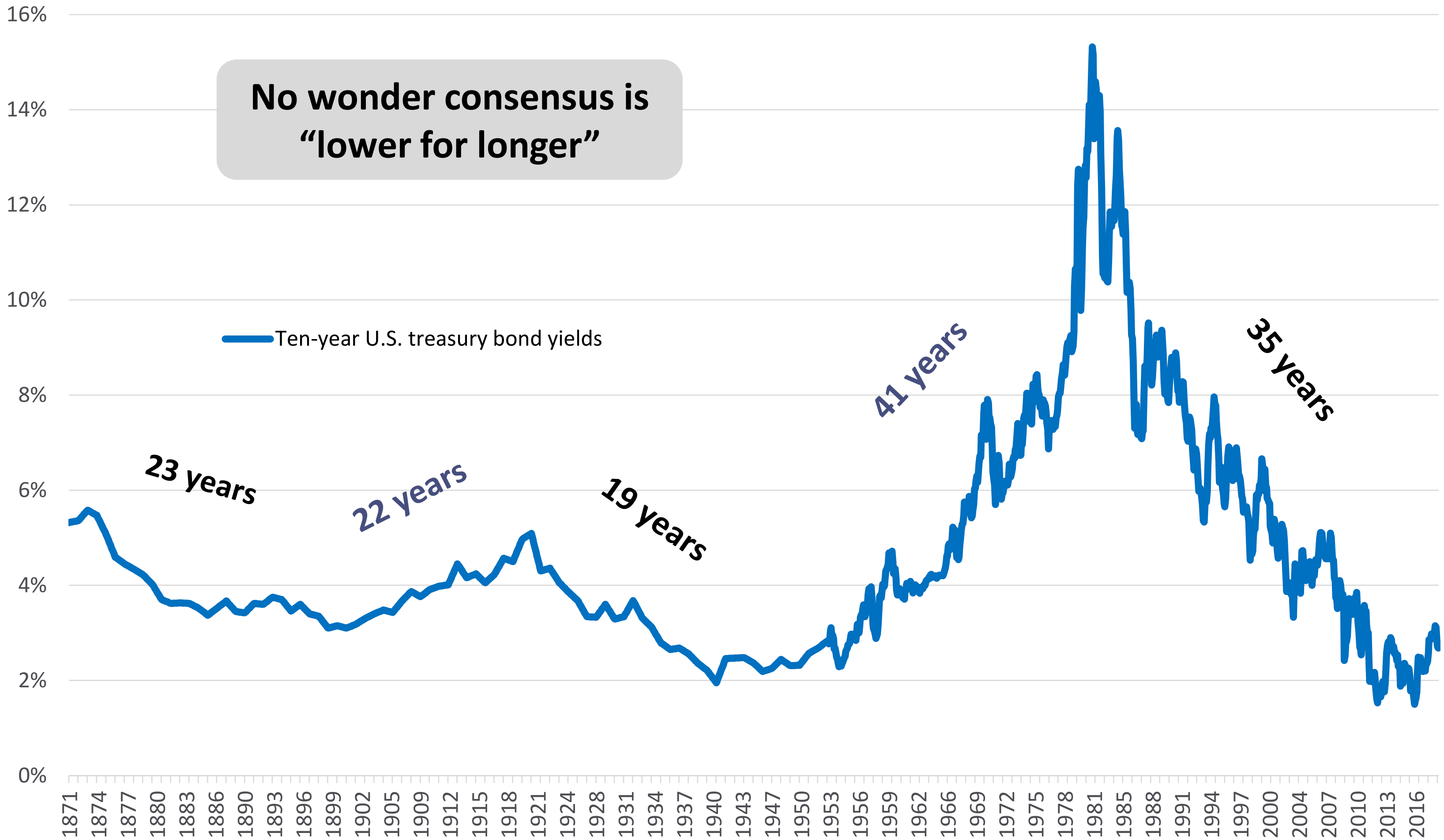
Long cycles: US treasury bond yields



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The next cycle?

- Could be mildly inflationary growth
  - Analog years: 1950s, 1960s
    - Good economy; modest inflation
    - Rising wages; good job growth
    - Create a thriving middle class
  - Why might inflation stay muted?
    - Technology caused disinflation
    - Too much debt to create inflation
    - Fed already too restrictive
    - China conflicts: devaluation; South China Sea

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Thank you

Questions?

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