Principal Global Investors

Morley Capital Management

Economic and market review

Second quarter 2019

Morley Capital Management (Morley), a specialized investment boutique of Principal Global Fixed Income.

Morley's macro themes

As of June 30, 2019

Trade war. Will it escalate?

- ***Base view:*** We believe an eventual agreement between China and US will "normalize" relations somewhat. Tariffs will be reduced/eliminated and trade will resume. However, we believe the path to resolution will be bumpy. Reconciling the last "10%" of the agreement will be the hardest with codification/enforcement of technology transfers appearing to be the stumbling block. As we've seen with the recent G20 summit, both sides want to do a deal and keep the momentum going. We believe Trump will want to complete the deal before the 2020 general elections as a signature accomplishment while Premier Li will be motivated by the further deterioration of China's economy.

- ***Where could we be wrong?*** Despite the recent détente between the two parties, we may need to see a significant sell off in markets to push the two parties into a deal. China may view a better deal from a Biden presidency and therefore be willing to sustain short term pain.

Will central banks continue to support markets?

- ***Base view:*** Post Powell's Congressional testimony and Fed minutes, we maintain that global central banks will provide a back stop to asset prices. Globally, we see all central banks pivoting away from tightening to accommodation and providing synchronized easing. The ECB's recent comments have re-started discussions of QE and further negative rates in Europe and China has been ready to turn on the liquidity spigots. In contrast to 4Q18's tone deaf Fed, we see a Chairman that is more attuned with what the market is telling him.

- ***Where could we be wrong?*** The key to our view is whether the central banks are perceived to be inline/ahead of the market vs. oblivious/behind market expectations. If higher than expected inflation emerges, it may force the Fed to hike rates despite low economic activity.

Inflation lower for longer?

- ***Base view:*** Inflation has been stubbornly low and below the Fed's target. Part of our view of a dovish Fed has been the persistently low inflation data. We expect inflation pressures to be very mild for the foreseeable future.

- ***Where could we be wrong?*** Labor constraints finally create meaningful wage pressure.

Morley's macro themes

As of June 30, 2019

Global growth slowdown a soft patch or recession?

- ***Base view:*** After a strong 1Q19, we expect US and global growth to slow over the next 12 months. Recent activity has slowed including global manufacturing PMI's in China, EM, EU, and Japan all below 50. Despite near term loss of momentum, we believe growth will stabilize slightly below potential (2% GDP). Additional global stimulus will aid in economic activity as financial conditions have improved. Similar to 2015/16, we would expect a manufacturing "recession", but a stable consumer (70% of economy) would provide a ballast to GDP growth.

- ***Where could we be wrong?*** Inverted treasury curves and possible earnings recession flash warning signals. Contagion from manufacturing to the services/labor markets could portend a larger downside in economic activity. Finally, we could see that the damage has already been done by the current tariffs and trade uncertainty. Any cyclical upturn would be limited.

Political risks dormant but potentially rising?

- ***Base view:*** As we approach the 2nd half of this year we see several catalysts for market volatility. First, in the US presidential elections we could see headlines from progressive Democratic candidates that may be viewed as unfriendly to markets. Possible examples include Medicare-for-all (Healthcare), Cap&Trade (Energy), M&A (TMT) and the roll-back of deregulation. Since most/all deregulation is through executive order, those could be easily reversed. Second, we could see Trump energizing his base using tariffs to accomplish his immigration issues (Mexico). Third, acrimony between the White House and Congress leads to a failure in approving a higher debt ceiling. Fourth, we see potential hard Brexit headlines as we get closer to the Oct 31st deadline. We view these all as headline risks that contribute to market volatility, but that do not impact fundamentals.

- ***Where could we be wrong?*** A Democratic president/Congress ushers in a sweeping change in policies.

What's driving the market?

As of June 30, 2019

Trade talk or no trade talk

- Trade talks have been in the headlines throughout the quarter and led to increased market volatility:
    - **May 10, 2019** – President Trump announced that the U.S. will raise tariffs on $200 billion worth of imports from China from 10% to 25%, following through on previous threats. President Trump also threatened to impose an additional 25% tariff on $325 billion worth of imports from China.
    - **May 22, 2019** - The Trump administration has announced that the U.S. will lift steel and aluminum tariffs on Canada and Mexico. In response, Canada and Mexico have announced that they will lift their retaliatory tariffs on the U.S.
    - **May 31, 2019** - President Trump threatened to impose tariffs at a rate of 5% on all imports from Mexico, worth $346.5 billion, until, he said, illegal immigration across the southern border was stopped. The tariffs would begin on June 10.
    - **June 10, 2019** - President Trump said that the previously announced tariffs against Mexican products, scheduled to begin at a rate of 5% in June and gradually rise to 25%, were indefinitely suspended.
    - **June 30, 2019** – President Trump and Chairman Xi agreed to resume negotiations. The U.S. agreed to soften its stance against some sales of technology to Chinese telecom giant Huawei. China will resume purchases of American agricultural exports. Neither side will levy new tariffs while negotiations continue.

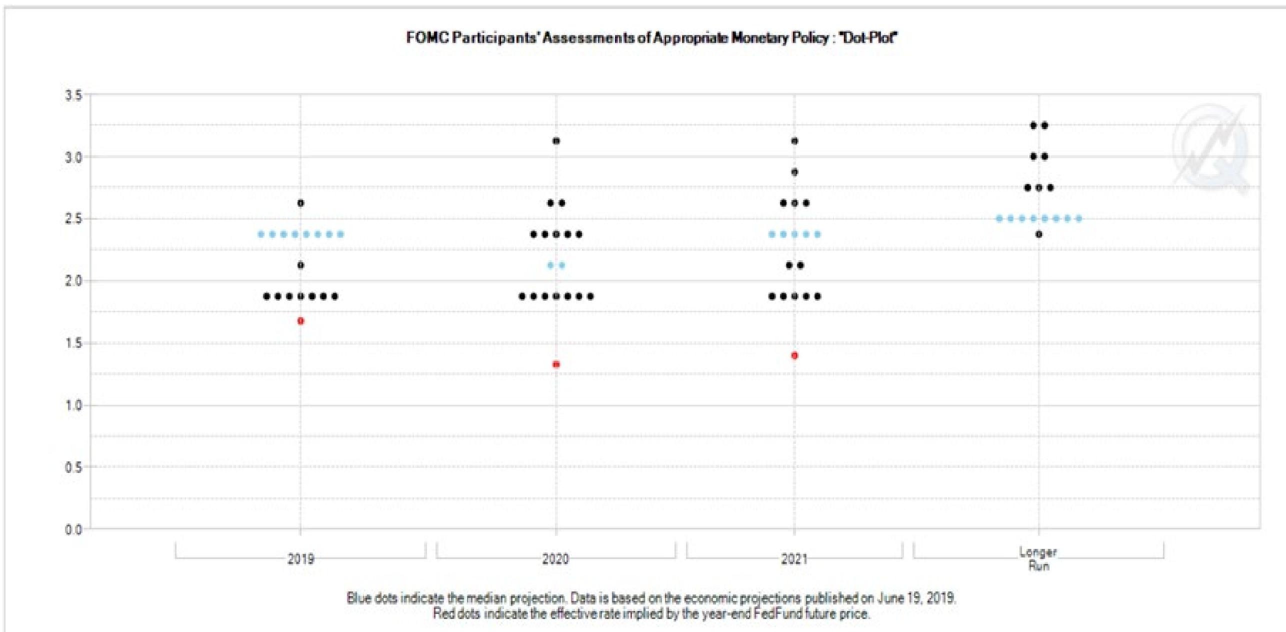
- We believe Tariffs are a drag on the global economy. Beyond increased costs, they disrupt global supply chains and cause increased uncertainty around capital spending plans.

What’s driving the market?

As of June 30, 2019

Is the Fed backtracking?

- In previous quarters the question was did the Fed go too far? In recent meetings, the Fed seems to be in full backtrack mode. Markets still believe the Fed’s expectations for future rates are too high. Below is a chart showing the Market’s expectation (red dots) compared to the Fed’s dot plot:



Note: Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate.

- The stock market’s immediate reaction to a potential more dovish Fed has led to a positive resurgence in equity markets and plummeting long-term bond yields. Is a more dovish Fed a sign that economic activity may be slowing, which would be negative for equity markets, or simply the product of uber-dovish central banks? We will find out.

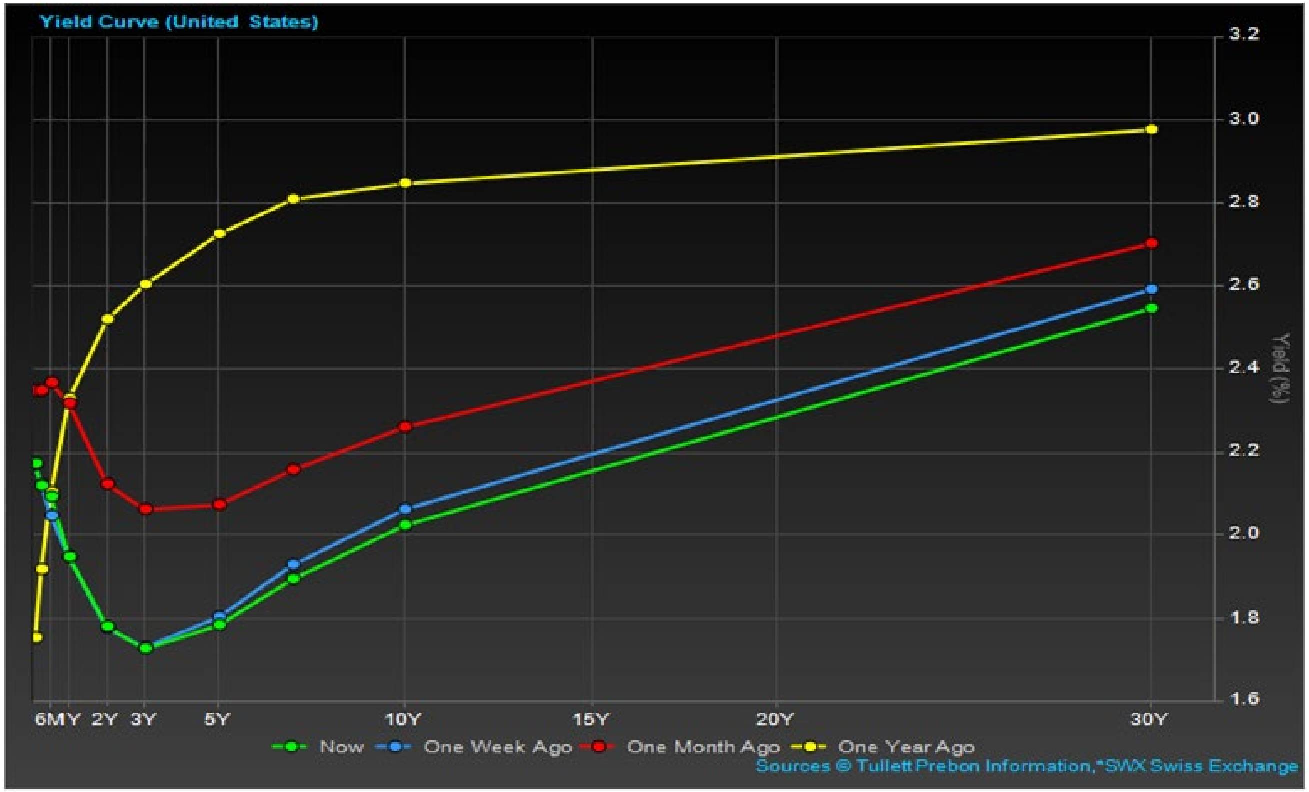
Source: CME Group

What's driving the market?

As of June 30, 2019

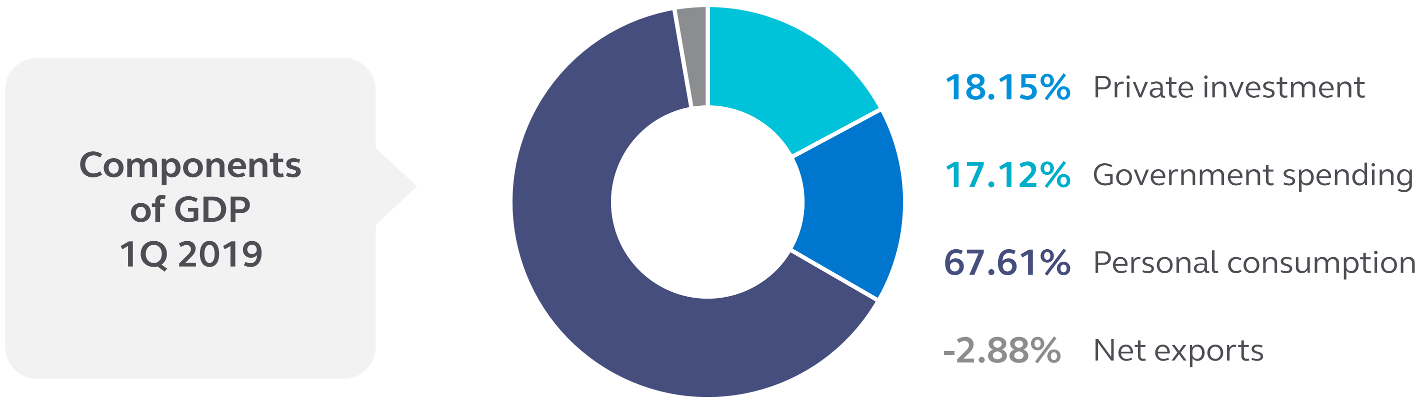
Is the Fed backtracking?

- Meanwhile, the bond market appears to be worried about the chances of recession as rates along the curve have dropped severely over the last 9 months.

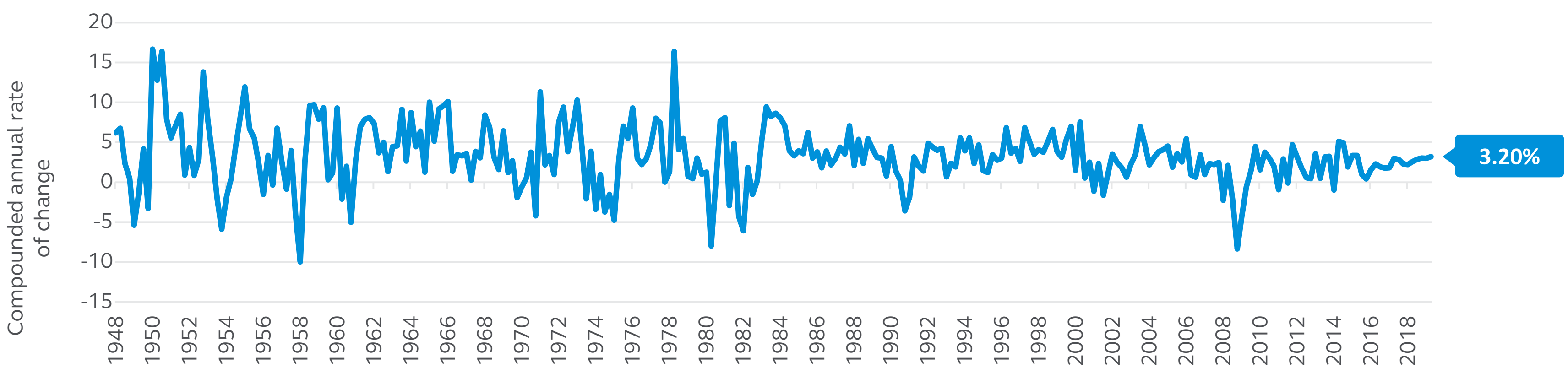


Source: CME Group

Composition and growth of Gross Domestic Product (GDP)



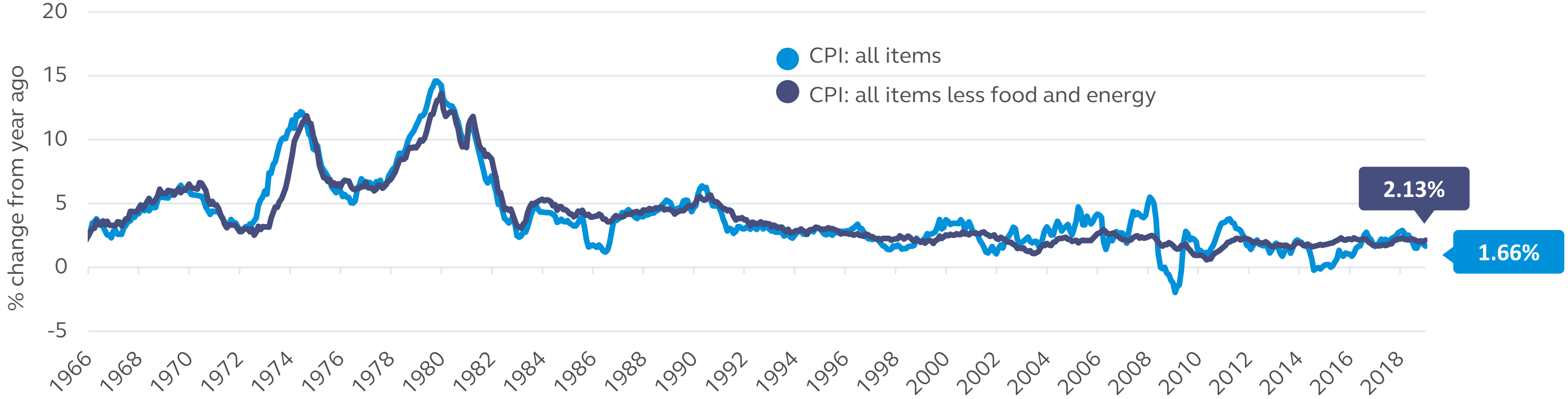
Change in real GDP over time (as of April 1, 2019)



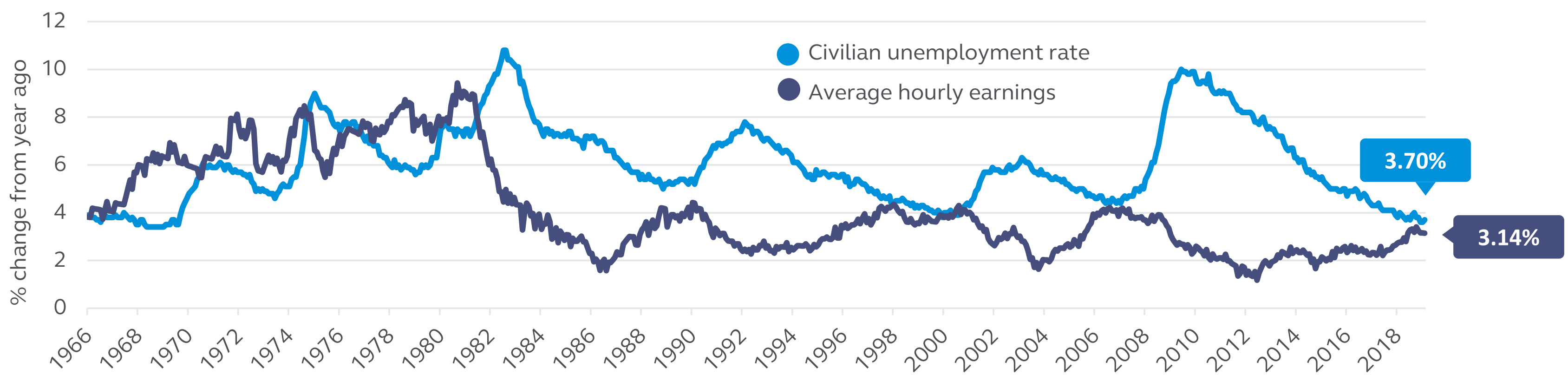
Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Inflation and the labor market

Consumer price index (CPI) and core CPI (as of June 1, 2019)



Unemployment and wages (as of June 1, 2019)



Source: U.S. Bureau of Labor Statistics.

Inflation and capital market yields

As of June 30, 2019

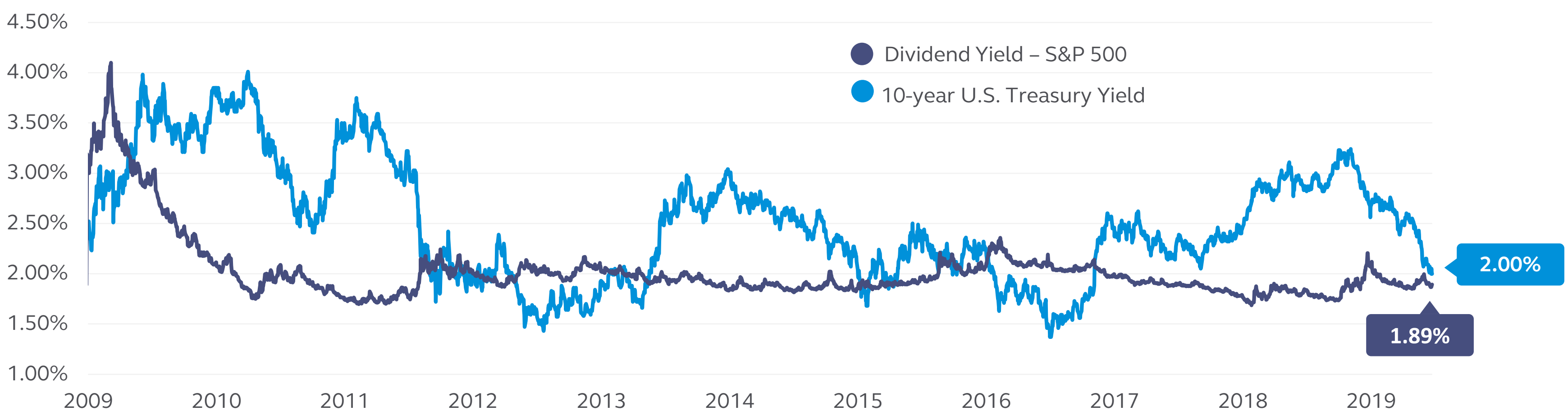
	10-year Treasury nominal yield	Inflation expectation
10-year average	2.49%	2.00%
June 2019	2.00%	1.69%

Real Treasury yield:

10-year average: **0.48%**

June 2019: **0.31%**

Capital market yields over time



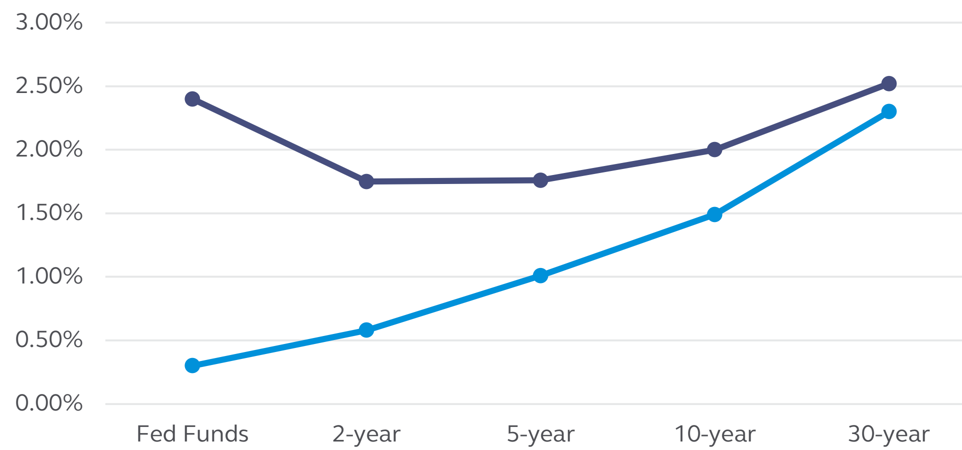
Source: FactSet. Past performance does not guarantee future results. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index. See Important Information for indices.

The history of interest rates

As of June 30, 2019

How have interest rates changed in recent years?

	June 2016	June 2017	June 2018	June 2019
2-year	0.58%	1.38%	2.52%	1.75%
5-year	1.01%	1.89%	2.73%	1.76%
10-year	1.49%	2.31%	2.85%	2.00%
2 to 10-year spread	0.91%	0.93%	0.33%	0.25%
30-year	2.30%	2.84%	2.98%	2.52%

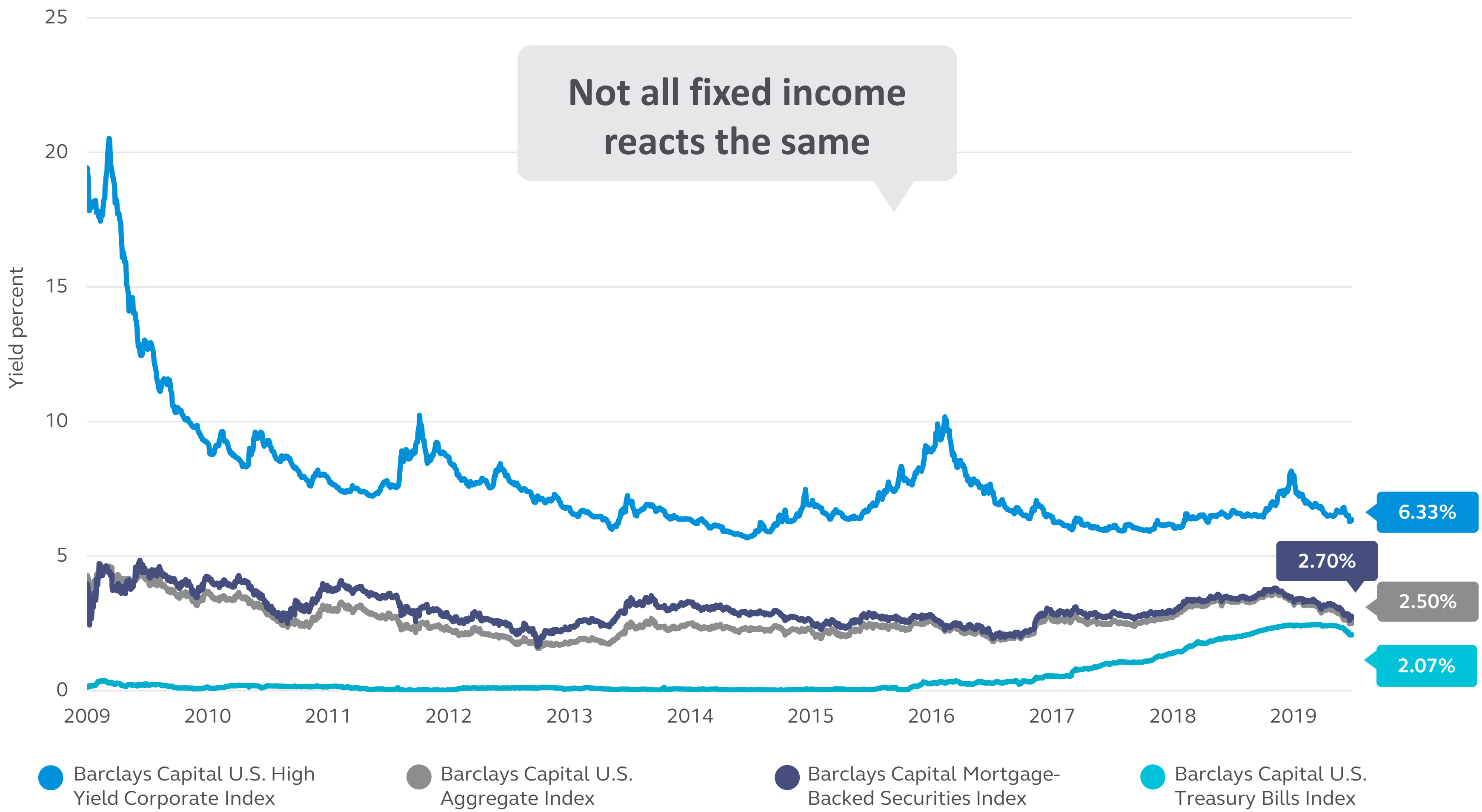


	Fed Funds	2-year	5-year	10-year	30-year
June 30, 2019	2.40%	1.75%	1.76%	2.00%	2.52%
June 30, 2016	0.30%	0.58%	1.01%	1.49%	2.30%

Source: FactSet.

The history of fixed income and market shifts

As of June 30, 2019



Source: FactSet. Past performance does not guarantee future results. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index. See Important Information for indices.

Asset class performance

Investment styles go in and out of favor over time

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Annualized 15-year return 12/31/2018
LargeCap Growth	11 6.30%	8 5.26%	11 9.07%	4 11.81%	7 -38.44%	4 37.21%	7 16.71%	5 2.64%	8 15.26%	4 33.48%	3 13.05%	2 5.67%	9 7.08%	2 30.21%	3 -1.51%	2 8.68%
LargeCap Value	6 16.49%	7 7.05%	5 22.25%	9 -0.17%	5 -36.85%	10 19.69%	8 15.51%	6 0.39%	4 17.51%	5 32.53%	2 13.45%	8 -3.83%	2 17.34%	6 13.66%	7 -8.27%	7 7.04%
MidCap Growth	7 14.83%	5 11.30%	10 9.68%	5 10.49%	11 -44.94%	3 44.48%	3 25.09%	7 -2.59%	10 14.50%	3 34.31%	6 10.71%	5 -1.27%	10 6.04%	4 23.93%	6 -5.68%	6 7.90%
MidCap Value	4 20.99%	6 10.25%	6 17.63%	10 -3.45%	9 -40.17%	7 30.50%	5 22.13%	9 -3.57%	7 15.77%	6 30.70%	4 12.42%	10 -6.87%	3 17.22%	7 10.86%	12 -14.29%	10 6.18%
SmallCap Growth	9 14.31%	10 4.15%	8 13.35%	6 7.05%	8 -38.54%	5 34.47%	1 29.09%	8 -2.91%	9 14.59%	1 43.30%	8 5.60%	6 -1.38%	6 11.32%	5 22.17%	8 -9.31%	5 7.96%
SmallCap Value	3 22.25%	9 4.71%	4 23.48%	11 -9.78%	4 -28.92%	9 20.58%	4 24.50%	10 -5.50%	2 18.05%	2 34.52%	9 4.22%	11 -7.47%	1 31.74%	8 7.84%	9 -12.86%	9 6.91%
International	5 20.84%	3 14.96%	3 26.23%	3 12.92%	10 -43.23%	6 34.39%	11 9.43%	11 -11.78%	5 17.02%	7 21.57%	12 -3.88%	7 -2.60%	11 3.29%	3 24.81%	10 -13.64%	11 5.28%
Emerging Markets	2 25.95%	1 34.54%	2 32.55%	1 39.82%	12 -53.18%	1 79.02%	6 19.20%	12 -18.17%	1 18.63%	12 -2.27%	11 -1.82%	12 -14.60%	5 11.60%	1 37.75%	11 -14.25%	3 8.26%
Core Bonds	12 4.34%	12 2.43%	12 4.33%	7 6.97%	1 5.24%	11 5.93%	12 6.54%	3 7.84%	12 4.22%	11 -2.02%	7 5.97%	4 0.55%	12 2.65%	12 3.54%	2 0.01%	12 3.87%
High Yield Bonds	10 11.13%	11 2.74%	9 11.85%	8 1.87%	3 -26.16%	2 58.21%	9 15.12%	4 4.98%	6 15.81%	9 7.44%	10 2.45%	9 -4.47%	4 17.13%	9 7.50%	4 -2.08%	8 7.00%
Real Estate Securities	1 31.49%	4 12.13%	1 35.92%	12 -16.82%	6 -37.97%	8 28.61%	2 28.48%	2 8.69%	3 17.77%	10 2.47%	1 30.38%	3 2.52%	8 8.60%	11 5.07%	5 -4.57%	4 8.20%
Direct Property	8 14.48%	2 20.06%	7 16.59%	2 15.84%	2 -8.00%	12 -6.85%	10 14.52%	1 14.87%	11 10.63%	8 11.64%	5 12.38%	1 15.17%	7 9.27%	10 6.96%	1 8.32%	1 10.10%

As of December 31, 2018. Source: Bloomberg.

Past performance does not guarantee future results. Asset allocation and diversification do not ensure a profit or protect against a loss. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index.

Our forecast for the future

The global economy is amid its third mid-cycle slowdown. Like the 2015 slowdown, weakness seems isolated to the industrial sector and should not spread to consumers.

- **Europe:** European growth has disappointed, but the outlook is slightly better. Targeted stimulus plans in China suggest their economy will stabilize in the second half of 2019 and have a positive impact on European exports. Tightening labor markets in many parts of Europe will provide a boost and the ECB's clear intent to provide more stimulus should help support confidence and investment. There are still political uncertainties (Brexit, a potential new ECB president and Trump's renewed focus on protectionism around the auto industry) to work through. We expect growth in the region of around 1.0%.
- **Japan:** First quarter growth surprised on the upside coming in at 2.2% annualized, making two quarters at 2.0% after a third quarter contraction last year. Household consumption should remain the economic driver supported by an extremely tight labor market. The planned 2% VAT increase in October could have a positive impact on Q3 GDP but would be a drag on future quarters. GDP growth should be in the 1.0% range this year.
- **China:** The U.S. - China trade dispute is having a negative impact on China's growth. The goal in China is to keep growth at target at all costs. Officials have ended their deleveraging campaign, they have cut taxes for households and businesses, reduced required bank reserves, increased infrastructure spending, lowered interest rates, and loosened restrictions on pollution. The growth rate for 2019 should be around 6%, but could fade in 2020 as the stimulus wanes, the labor force continues to shrink and the impact of trade problems can no longer be averted.
- **U.S.:** Excess inventories and trade uncertainties kept industrial output and capital spending lackluster through mid-year. We expect better growth in the second half of the year. Housing will add to GDP with lower rates. Trade uncertainties are not impacting small business where expansion plans, and optimism are near records. A tightening labor market and robust wage gains are pulling people back into the labor market raising total household incomes. We expect 2% to 2.5% growth this year and into next.

Baseline	2Q 2019	3Q 2019	4Q 2019	2019	1Q 2020	2Q 2020	3Q 2020	4Q 2020	2020
GDP q/q ar	1.10%	2.50%	2.60%	**2.50%**	2.50%	2.60%	2.40%	2.30%	**2.40%**
Consumer spending	3.00%	2.70%	2.50%	**2.50%**	2.70%	2.70%	2.60%	2.60%	**2.70%**
Unemployment	3.60%	3.50%	3.50%	**3.60%**	3.40%	3.30%	3.30%	3.20%	**3.30%**

As Of June 30, 2019. These forecasts represent the current views and opinions of Principal Global Investors and are not intended to be, nor should it be relied upon in any way as a guarantee of future events regarding particular investments or the markets in general. Current views should not be considered as a comprehensive statement and should not be relied upon as such nor should it be construed as specific investment advice or recommendation.

Important information

Index descriptions

Related to slide 12:

Barclays Capital U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Pay-in-kind (PIK) bonds, Eurobonds, and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, and 144-As are also included. The index includes both corporate and non-corporate sectors. Information regarding the comparison to the Barclays Capital U.S. High Yield Index is available upon request.

Barclays Capital Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. The lower limit of par outstanding is $250 million. Information regarding the comparison to the Barclays Capital Aggregate Index is available upon request.

Barclays Capital Mortgage-Backed Securities (MBS) Index covers agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). Introduced in 1986, the GNMA, FHLMC, and FNMA fixed-rate indices for 30- and 15-year securities were backdated to January 1976, May 1977, and November 1982, respectively. Balloon securities were added in 1992 and removed on January 1, 2008. 20-year securities were added in July 2000. On April 1, 2007, agency hybrid adjustable-rate mortgage (ARM) pass-through securities were added to the Barclays Capital MBS Index. Hybrid ARMs are eligible until one-year prior to their floating coupon date. Information regarding the comparison to the Barclays Capital MBS Index is available upon request.

Barclays Treasury Bill Index includes U.S. Treasury bills with a remaining maturity from one up to (but not including) 12-months. It excludes zero coupon strips.

Related to slide 13:

Large-Cap Growth stocks are represented by the annual total returns of the Russell 1000 Growth Index, which is a market-capitalization weighted index of those firms in the Russell 1000 with higher price-to-book ratios and higher forecasted growth values.

Large-Cap Value stocks are represented by the annual total returns of the Russell 1000 Value Index, which is a market-capitalization weighted index of those firms in the Russell 1000 with lower price-to-book ratios and lower forecasted growth values.

Mid-Cap Growth stocks are represented by the annual total returns of the Russell Mid Cap Growth Index, which is a market-weighted total return index that measures the performance of companies within the Russell Mid Cap Index having higher price-to-book ratios and higher forecasted growth values.

Mid-Cap Value stocks are represented by the annual total returns of the Russell Mid Cap Value Index, which is a market-weighted total return index that measures the performance of companies within the Russell Mid Cap Index having lower price-to-book ratios and lower forecasted growth values.

Small-Cap Growth stocks are represented by the annual total returns of the Russell 2000 Growth Index, which is a market-weighted total return index that measures the performance of companies within the Russell 2000 Index having higher price-to-book ratios and higher forecasted growth values.

Index descriptions

Related to slide 13 (continued):

Small-Cap Value stocks are represented by the annual total returns of the Russell 2000 Value Index, which is a market-weighted total return index that measures the performance of companies within the Russell 2000 Index having lower price-to-book ratios and lower forecasted growth values.

International stocks are represented by the annual total returns of the MSCI EAFE Index, which is listed for foreign stock funds (EAFE refers to Europe, Australasia, and Far East) and is widely accepted as a benchmark for international stock performance, the EAFE Index is an aggregate of 21 individual company indexes.

Emerging Markets stocks are represented by the annual total returns of the MSCI EMF Index, which is an index composed of companies representative of the market structure of 25 emerging market countries in Europe, Latin America, and the Pacific Basin.

Core Bonds are represented by the annual total returns of the Barclays Aggregate Index, which covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

High yield bonds are represented by the annual total returns of the Barclays High Yield Index, which is an unmanaged index constructed to mirror the characteristics of the high yield bond market.

Real Estate Securities are represented by the annual total returns of the NAREIT Index, which is a capitalization-weighted benchmark index of most actively traded Real Estate Investment Trusts (REITs), designed to measure real estate performance.

Real Estate Direct Property is represented by the annual total returns of the NCREIF Fund Index – Open End Diversified Core Equity (NFI-ODCE) Equal Weight Index, which is a fund-level, gross of fee, time-weighted return index. Funds contributing data to the NFI-ODCE are generally "core" and must market themselves as an open-end commingled fund pursuing a diversified core investment strategy, primarily investing in private equity real estate with at least 80% of the market value of real estate net assets invested in operating properties. As of December 31, 2016 there were 24 data-contributing funds in the NFI-ODCE.

Important information

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