CIO Viewpoints

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A look at the markets

Economies and markets have been synchronized, stable, and successful.

Steady, synchronized global expansion

+

High liquidity, low inflation

=

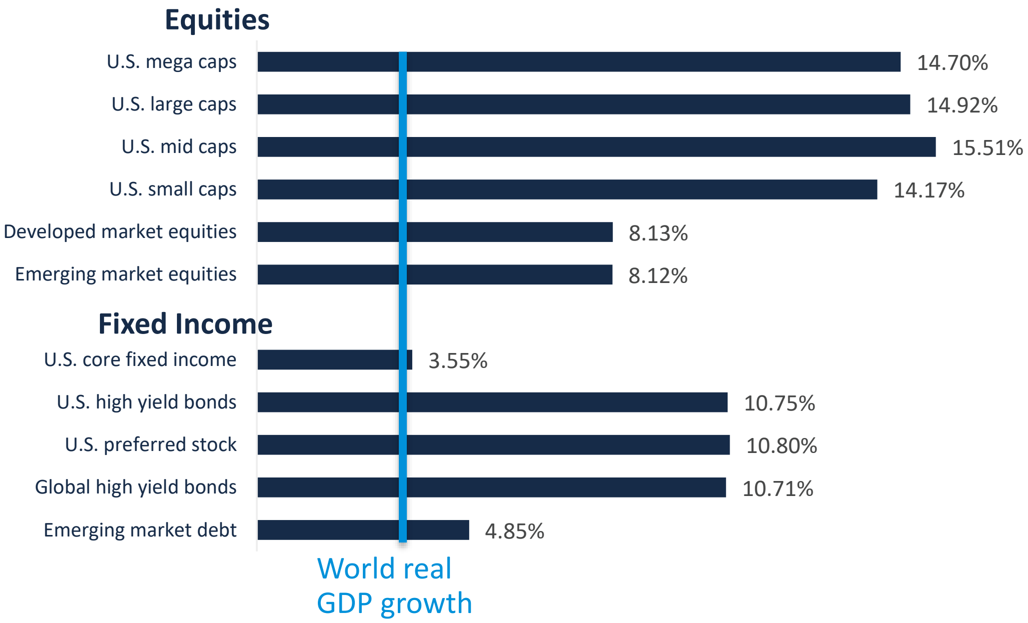
Robust sales, profit growth and margins

Principal®

Soaring risk assets

Since the financial crisis risk assets have outpaced economic growth.

Annualized growth rates since 2009



2.46%

World real GDP growth*

For CFA Society use only. As of 31 December 2018. Source: Bloomberg. Time period: 31 March 2009 to present. Asset classes measured by the following indexes from top to bottom: Russell 3000, MSCI Europe, MSCI Japan, MSCI Asia Pacific ex. Japan, MSCI EM, Bloomberg Barclays Aggregate Bond Index, Bloomberg Barclays Global Aggregate Index, Bloomberg Barclays Global High Yield Index, Bloomberg Barclays EM Hard Currency Aggregate Index. It is not possible to invest in an index. *World GDP growth data is as of 31 December 2017.

Divergence from long-term averages

Returns have increased above long-term averages and volatility has plummeted.

Higher return than average

- US mega-cap equities
- US large-cap equities
- US mid-cap equities
- US small-cap equities
- US preferred stock
- Global high yield bonds
- Emerging market debt

- US high yield bonds

Lower volatility than average

Higher volatility than average

- Emerging market equities
- US core fixed income

Lower return than average

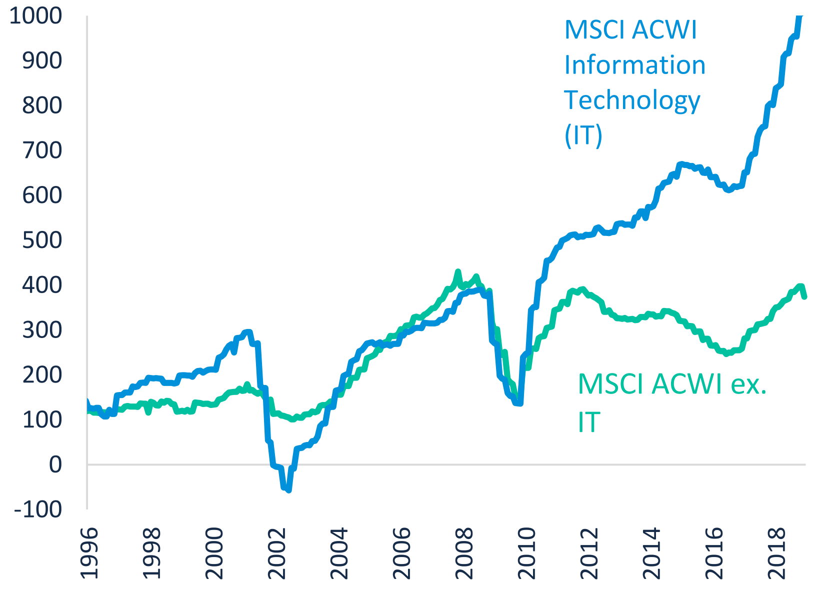
For CFA Society use only. As of 31 December 2018. Source: Morningstar. Long-term time frame is 20 years prior to the financial crisis: 01 April 1989 to 01 April 2009. If the index was not incepted yet in 1989, data is as of index inception. Asset classes measured by the following indexes: Russell Top 200, Russell 1000, Russell Mid Cap, Russell 2000, MSCI EAFE, MSCI EM, Bloomberg Barclays Aggregate Bond Index, Bloomberg Barclays US High Yield 2% Issuer Capped Index, ICE BoAML Fixed Rate Preferred Index, Bloomberg Barclays Global High Yield Index, Bloomberg Barclays EM Hard Currency Aggregate Index.

Technology decoupling

Technology earnings have decoupled from the rest of the market.

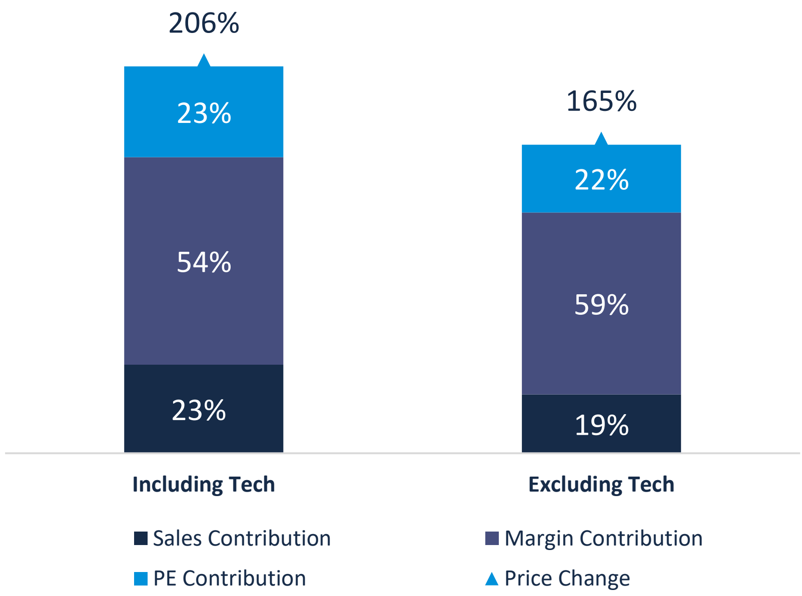
Tech earnings are a secular growth force

Trailing 12 month earnings per share (EPS)



Tech makes everything better

S&P 500 ex. financials, real estate, utilities



For CFA Society use only. As of 31 December 2018. Source: Bloomberg. Growth indexed to 100 on left chart.

Investors on autopilot

Investors are underestimating risk and overestimating returns.

Recency bias

Built-up hidden risk

Fear of missing out

Recession indicators

3 of our 19 recession indicators have a recession signal

		Indicator
Consumer	1	University of Michigan consumer sentiment (YoYΔ)
	2	Housing starts (2yr/2yr)
Employ-ment	**3**	**Average hourly earning for production and nonsupervisory workers (YoY%)**
	4	Total private employment level (YoY%)
	5	Philadelphia Fed coincident diffusion index
	6	Initial jobless claims (YoY%)
	7	Hours worked: non-financial corporations (YoY%)
Business	8	Industrial production index (YoY%)
	9	% of industrial production markets expanding YoY (% of total)[1]
	10	Domestic corporate profits (YoY%)
	11	Private investment's share of GDP (YoYΔ)
	12	Business loan delinquency rate (YoYΔ)
	13	Tighter lending standards index
Financial	14	6 month leading WTI oil price (2yr/2yr)
	15	**S&P 500 (6m/6m)**
	16	**S&P 500 (YoY%)**
	17	1 year leading US Treasury Spread (10 year US Treasury – 2 year US Treasury)
	18	High yield YTW spread (YTW – 10 year US Treasury)
	19	GDP spread (10 year US Treasury – nominal GDP YoY%)

Indicators signaling a recession

For CFA Society use only. As of 31 December 2018. Source: Bloomberg. Probability of recession is based on a probit regression model and is subject to error as observations may differ from their expected value. As with any statistical model it provides an estimate of the future state of the economy and results can vary. Proprietary model output is based upon certain assumptions that may change, are not guaranteed and should not be relied upon as a significant basis for an investment decision. For illustrative purposes only. More information on the probability model is available on request. YoY stands for year over year. [1]Source: FRED.

An asset allocator's view of the world

We forecast reduced returns, increased risk, and potentially lower correlations.

μ
Returns
↓

σ
Risk
↑

ρ
Correlations
↓?

Our positioning

Portfolio positioning in our U.S. target risk portfolios.

True north:

The beginning of your asset allocation with a neutral risk appetite

We have a preference for:

- U.S. equities (large caps, low-vol, and quality)
- Short duration credit
- Long-horizon active management
- Multi-alternatives

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