Market Bulletin

January 2015

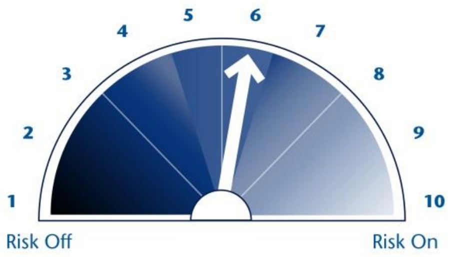
The Fixed Income Strategy Group of Principal Global Fixed Income uses a Dynamic Risk Score to provide consistent communication of our market outlook. The Dynamic Risk Score is a 10-point scale where a score of 1 represents the worst risk-taking environment and a score of 10 represents the best risk-taking environment. Investment teams use this score to guide investment decisions and adjust the level of risk in portfolios as market conditions change.

Dynamic Risk Score

The Fixed Income Strategy Group lowered the Dynamic Risk Score from 7 to 6, reflecting:

- Heightened equity and U.S. Treasury volatility
- Uncertainty regarding:
  - Global inflation and growth
  - Timing of possible interest rate hikes
  - Willingness of Europe to implement large scale sovereign asset purchases
  - Effectiveness of Bank of Japan quantitative easing policies
  - Path and implications of oil prices

Dynamic Risk Score
(risk relative to reward)



Current Market View

We believe that in the current risk-taking environment, risk product is likely to outperform U.S. Treasury securities over the next three to six months with spreads in a range.

- Falling oil prices should positively affect U.S. real GDP growth. However, we expect volatility to continue as the market works out the supply/demand imbalance and oil prices stabilize. Falling oil prices could potentially have negative consequences:
  1. Higher default rate and wider spreads in energy related sectors;
  2. Pressure on sectors and companies that have either direct balance sheet exposure to energy or which may be directly impacted by reductions in energy production;
  3. Some reduction effect on GDP through reduced energy and related sector employment, construction, and other service-related sectors, which have served the boom in U.S.-related energy infrastructure over the past several years;
  4. Potential geo-political pressures, which may arise due to social unrest in oil producing countries.
- Slow economic growth outside of the United States. Europe is struggling; Japan is not yet improving even with central bank actions; and China is slowing.
- Risk of global deflation. Wages in the United States have remained on a lower path than what would normally be expected at this stage of job growth and unemployment. We do expect inflation and wages to accelerate mildly through the year, pushing the Federal Reserve to increase interest rates in two, 25 basis point increments, beginning sometime between June and September 2015.

MARKET WATCH

The following are two potential market catalysts to watch for that could cause volatility to move higher and negatively impact spreads:

1. Corporate profit margins remain historically high, benefitting from disciplined hiring, limited business expansion, and low interest rates. If companies begin to hire more people relative to growth or to more aggressively expand, this may reduce profit margins.
2. Falling energy prices could have ongoing broad economic and geo-political risks, which we may only become apparent through time. If these risks prove to be greater than our current expectations, credit spreads could be negatively impacted.

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