Market bulletin
February 2018

The Fixed Income Investment 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 Investment Strategy Group has lowered the Dynamic Risk Score from a 7 to a 6, as a result of the following influences:

- Possible regime changes regarding investors’ view of central bank policy
- Heightened interest rate and equity volatility
- Given heightened volatility, possible additional leverage issues embedded within the financial system

Current market view
Our decision to decrease the Dynamic Risk Score reflects our belief that we are currently in an environment that is less conducive to risk taking than that of late 2017. We will continue to monitor the market, but for now we have decreased the score for a number of reasons:

- **Possible regime changes regarding investors’ view of central bank policy**
  Although we continue to witness very strong economic fundamentals globally, the strength of those metrics is starting to impact investors’ views on global central back policy. Strong nominal growth, combined with increased inflation fears and reduced central bank balance sheets, has shifted the debate from how accommodative central banks will be to how aggressive they will be in the face of such strength. In addition, questions remain regarding how accommodative central banks would be in the face of another bout of extreme volatility, or even a crisis event. Given that each of the main central banks (Federal Reserve, European Central Bank, Bank of Japan, and People’s Bank of China) is at different stages of their mandates and economic cycles, the likelihood of a coordinated, unified response is more in question now than in years past.

- **Heightened interest rate and equity volatility**
  Recent volatility in the rate and equity markets, coupled with the lack of significant spread widening across risk assets within fixed income, warrants a reduction in the Dynamic Risk Score. The rates markets are beginning to price in reflation fears, especially in the United States. In addition, after years of falling, U.S. Treasury term premiums increased significantly, indicating a possible different market dynamic than the “low-rate, low-volatility” environment that many have become accustomed and possibly complacent to.

- **Given heightened volatility, possible additional leverage issues embedded within the financial system**
  Part of the extreme market reaction on February 5 was due to financial innovations like inverse and triple-leveraged exchange-traded notes. Although we believe the overall impact from the losses in these products is currently contained, history has taught us that extreme moves in one segment of financial markets can at times expose other similar, extreme-leverage situations. We believe it is prudent to allow some time to pass and ensure that no secondary effects occur.

For more information, please visit principalglobalfixedincome.com
Regulatory risk warning

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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. International and global investing involves greater risks such as currency fluctuations, political/social instability and differing accounting standards.

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