Economic Insights

Commentary by Indraneel Karlekar, Zach Dietrich, and the Economic Committee

Topic Summaries:

- **Finally, a decent inflation print:**
  After months of underwhelming prints (five consecutive misses), the consumer price index (CPI) rose 0.4% in August, and core CPI inflation rounded up to 0.3%. The markets ratcheted up the probability of another interest rate increase in December, but we think the next one will be in March 2018.

- **Strong business confidence continues:**
  Strong flows of U.S. survey data continued in August with robust small business optimism and consumer confidence releases. Firms maintain that a tight labor market is a good problem to have.

- **Should auto loans be a worry?**
  There is increasing concern around the growth of sub-prime auto loans and the potential negative impact on lenders. Given the low level of securitization however, auto loans are not considered a systemic risk. The bigger risk is slowing sales, and the accompanying impact on retail spending and jobs.

For the week of September 11-15, 2017

Finally, a decent inflation print

It was a good week for the U.S. economy. After months of underwhelming prints (five consecutive misses), the consumer price index (CPI) rose 0.4% in August, and core CPI inflation rounded up to 0.3%. Temporary factors clearly helped in this rise in inflation, but underlying inflation also appears to firm with rent and owners' equivalent rent (OER) both rising at a cycle-high pace. Moreover, the full impact of Hurricanes Harvey and Irma are yet to be felt in the cost of labor or materials, which may give further impetus to inflationary readings in the coming months.

The gains in August puts CPI up 1.9% on a year-over-year basis and 2% annualized over the past three months. The biggest boost came from energy with CPI for energy increasing by 2.8% between July and August. However, food CPI print was weak, increasing by only 0.1%. The pressure on food pricing is likely to remain given the consolidation in the grocery retail industry from Amazon continuing to integrate its Whole Foods acquisition.

As is well known, inflation and the labor market are the two guardrails of Federal Reserve (Fed) policy, which have been at the heart of monetary policy. Does this improved inflation print materially change the Fed's thinking on monetary policy? The markets still think the odds of a Fed hike in 2017 are low, even though the odds of a December rate hike went up to 50% from 40%, perhaps in anticipation of strengthening inflation readings in the months ahead.

For the Fed to green light another interest rate increase later this year, the increase in CPI and core CPI need to be sustained. The Fed will have to be convinced that there aren't structural issues anchoring inflation in the United States. The most likely step is that the Fed keeps with its public stance of policy normalization but effectuates it via balance sheet reduction, which it could announce at its meeting next week. As the old adage goes, one swallow does not make a summer. And, one strong inflation print is unlikely to convince the Fed to move in 2017.

> **The most likely step is that the Fed keeps with its public stance of policy normalization but effectuates it via balance sheet reduction, which it could announce at its meeting next week.**
>
> Indraneel Karlekar • Senior Managing Director - Global Research and Strategy

Strong business confidence continues

Meanwhile, the Fed should feel more confident in its economic outlook given the flow of very strong survey data in August. The Small Business Optimism Index from the National Federation of Independent Businesses (NFIB) rose to a seven-month high of 105.3, just shy of a 12-year record posted in January.

Details of the NFIB report make for positive reading: in early 2010, only about 6% of firms cited the cost or quality of labor as their single biggest problem. In August, a whopping 26% cited these as major issues. That's more than the previous cycle high, and now the leading problem for the group. Moreover, 31% of small companies currently have a job opening they can't fill. This is troubling since it points to continuing skills shortage in the country, and encouraging since it suggests that payroll employment should stay on solid footing, and upward pressure is likely to be felt in wage growth going forward.

Small businesses say they are having trouble hiring new employees, but they are optimistic anyway. Tight labor markets are a good problem to have. Solid employment growth and more wage pressure should buoy consumer spending for a time.

› Count in consumers as well:

A strong labor market is clearly having a positive impact on consumer confidence, which increased to 122.9 in August, according to the Conference Board. That was the highest reading in two decades, second only to March 2017.

Negative headlines and geopolitical tensions haven't shown up in this reading. The assessment of present conditions last month increased almost six points to 151.2. Why was this the case?

Maybe it's the economy generally, and the labor market specifically. The unemployment rate is low at 4.4%. Initial jobless claims are ultra-low, if you adjust them for the size of the labor force. The difference between the Conference Board respondents saying jobs are plentiful and hard to get soared 3.6 points, to an astounding 18.1. That level on the labor differential has only been surpassed in the 1990's and late 1960's.

Should auto loans be a worry?

Amidst the general flow of good news, a potential sign of some concern is the increase in auto loan delinquencies. Auto sales have been a key component of the present expansion. In 2016, Americans bought more new light vehicles than ever before: 17.47 million units, representing an annual growth rate of about 11%. The 2016 pace of auto sales was hailed as a signal of growing confidence and indicative of a renewed willingness by households to save less, step up their borrowing, and spend more. Consumers closed out 2016 with $1,192 trillion of outstanding auto loans, based on Fed data, which constituted 29.4% of total outstanding consumer debt (excluding mortgage loans).

Total consumer loans are still slightly below the 2008 peak, but auto loans are well above pre-recession levels, having kept pace with auto sales. This has raised the specter that car buying bonanza financed by cheap credit is not likely to be sustainable.

Rising sub-prime delinquencies may also lead to widespread asset write-downs and the loss of equity by lending institutions to the point where the expansion is curtailed. Before a judgment is made, the most recent auto loan and delinquency statistics from the Federal Reserve Bank of New York should be assessed:

• Of the $1,192 trillion outstanding auto loans at the end of 2016, $404.4 billion, or 35.6% were sub-prime, meaning a credit score of 659 or less.
• Auto finance companies have 84% of all "super" sub-prime auto loans (those with a credit score of below 620), while banks and credit unions have the remainder 16%.
• As of the third quarter of 2016, 31% of all new auto loan originations were sub-prime, compared to 26.6% in second quarter 2010, and 38% in fourth quarter 2007.
• Auto loans 90 days plus delinquent posted a score of 3.75% at the end of 2016, compared to 5.25% in 2010, and 2.17% in 2000.

Losses on sub-prime up sharply:

The rise in 90-day-plus delinquency statistics on sub-prime auto loans is important because loss ratios on sub-prime loans rose to 9.1% in January 2017, from 8.5% in December 2016, and 7.9% in January 2016. These losses are the worst since January 2010 and are driven by much poorer recoveries after default; meaning when lenders get the vehicles back and sell them. The losses are occurring because of a flood of used cars coming off lease after several years of manufacturers/dealers offering generous lease terms.

But do auto loan delinquencies pose a systemic risk? Credit rating agency Fitch calculates that of the $1,192 trillion of auto loans outstanding, a mere $97 billion has been securitized. In contrast, in 2007, there was about $10 trillion U.S. mortgages outstanding of which approximately 70% had been securitized with enormous leverage. This helps provide some context to the current level of auto securitization; if sub-prime delinquencies increase, loss ratios should not blow up lender equity or start a chain reaction throughout the U.S. economy, like the housing/mortgage crisis.

At this point, it is hard to see auto loans as a source of large systemic risk. The bigger risk is that auto sales account for 20% of all retail spending and, directly or indirectly, make up one million jobs! A build up in unit inventories and falling production due to dealers having sold too aggressively, could take a bite out of growth and interrupt the expansion. It would not, however, threaten the financial system like the collapse of mortgage securitizations. Much of the sub-prime auto lending is by auto dealers who are better equipped to handle the collateral when necessary, even though slightly over half of all auto lending is sourced by banks and credit unions who bring much more discipline to the process.

Disclosures

Unless otherwise noted, all data is sourced from Bloomberg.

Unless otherwise noted, the information in this document has been derived from sources believed to be accurate as of September 2017. Information derived from sources other than Principal Global Investors or its affiliates is believed to be reliable; however, we do not independently verify or guarantee its accuracy or validity. Past performance is not necessarily indicative or a guarantee of future performance and should not be relied upon to make an investment decision.

The information in this document contains general information only on investment matters. It does not take account of any investor's investment objectives, particular needs or financial situation and should not be construed as specific investment advice, an opinion or recommendation or be relied on in any way as a guarantee, promise, forecast or prediction of future events regarding a particular investment or the markets in general. All expressions of opinion and predictions in this document are subject to change without notice. Any reference to a specific investment or security does not constitute a recommendation to buy, sell, or hold such investment or security, nor an indication that Principal Global Investors or its affiliates has recommended a specific security for any client account.

Principal Financial Group, Inc., Its affiliates, and its officers, directors, employees, agents, disclaim any express or implied warranty of reliability or accuracy (including by reason of negligence) arising out of any for error or omission in this document or in the information or data provided in this document.

Any representations, example, or data not specifically attributed to a third party herein, has been calculated by, and can be attributed to Principal Global Investors. Principal Global Investors disclaims any and all express or implied warranties of reliability or accuracy arising out of any for error or omission attributable to any third party representation, example, or data provided herein.

All figures shown in this document are in U.S. dollars unless otherwise noted.

This document is issued in:

• The United States by Principal Global Investors, LLC, which is regulated by the U.S. Securities and Exchange Commission.
• Europe by Principal Global Investors (Europe) Limited, Level 1, 1 Wood Street, London EC2V 7JB, registered in England, No. 03819986, which has approved its contents, and which is authorised and regulated by the Financial Conduct Authority.
• Singapore by Principal Global Investors (Singapore) Limited (ACRA Reg. No. 199603735H), which is regulated by the Monetary Authority of Singapore and is directed exclusively at institutional investors as defined by the Securities and Futures Act (Chapter 289).
• Australia by Principal Global Investors (Australia) Limited (ABN 45 102 488 068, AFS License No. 225385), which is regulated by the Australian Securities and Investment Commission and is only directed at wholesale investors (as defined in sections 761G and 761GA of the Corporations Act).
• This document is issued by Principal Global Investors LLC, a branch registered in the Dubai International Financial Centre and authorized by the Dubai Financial Services Authority as a representative office and is delivered on an individual basis to the recipient and should not be passed on or otherwise distributed by the recipient to any other person or organisation. This document is intended for sophisticated institutional and professional investors only.
• Japan by Principal Global Investors (Japan) Ltd. (Kanto Local Finance Bureau (Kinsho) No. 462, Japan Investment Advisers Association; Membership No. 011-01627).
• In Europe, this document is directly exclusively at Professional Clients and Eligible Counterparties and should not be relied upon by Retail Clients (all as defined by MiFID). In connection with its management of client portfolios, Principal Global Investors (Europe) Limited may delegate management authority to affiliates that are not authorised and regulated within Europe. In any such case, the client may not benefit from all protections offered by rules and regulations enacted under MiFID.
• India by Principal Pnb Asset Management Company Private Limited (PPAMC). PPAMC offers only the units of the schemes of Principal Mutual Fund, a mutual fund registered with SEBI.
• Hong Kong by Principal Global Investors (Hong Kong) Limited, which is regulated by the Securities and Futures Commission and is directed exclusively at professional investors as defined by the Securities and Futures Ordinance

This material is not intended for distribution to, or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.

Insurance products and plan administrative services provided through Principal Life Insurance Co. Principal Funds, Inc. is distributed by Principal Funds Distributor, Inc. Securities offered through Principal Securities, Inc., 800-547-7754, Member SIPC and/or independent broker/dealers. Principal Life, Principal Funds Distributor, Inc. and Principal Securities are members of the Principal Financial Group®, Des Moines, IA 50392.

MM8299-80

t170918061b

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.