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4Q 2009 Economic Commentary

On the Other Hand



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American Idle

In 2009, probably no other issue epitomized the pain of the recession, symbolized the difficulty consumers faced or crystallizes the risks of the nascent recovery as the level of unemployment. The work lives of millions of Americans became idle against their wishes and through no fault of their own as the financial

crisis spread across the country and around the world. What's in store for U.S. employment?

In most postwar recoveries, the question of job growth wasn't really a question...job creation was a result of economic growth; as a recovery gathered force, jobs quickly followed. The deeper the recession, the more rapid the subsequent recovery and the more robust would be the gain in jobs. Forecasting employment gains was a function of predicting economic growth. This was the model for a manufacturing-based economy that faced little foreign competition for its jobs. Now, however, U.S. production workers compete with millions of highly productive workers in foreign economies. So the collective decision of U.S. firms to expand production is no longer one of simply calling back laid off workers. It is also whether to re-open the factory at all, as production can occur in many parts of the world using local workers still able to produce to world standards.

This is not a new trend, but has been ongoing for 30 to 40 years and has produced a profound shift in U.S. jobs from manufacturing and basic production to service industries as the job creation mechanism and income generator. Financial and business services have been a

huge spark for U.S. jobs given the explosion in capital held by foreign countries and by individuals both directly and through 401(k) and other retirement plans. Financial and business services are the source of good, well-paying jobs which, added to with two-income households, made U.S. employment almost recession-proof. The two prior recessions of 1991 and 2001 had mild job losses since financial services were relatively unaffected. This Great Recession, however, was rooted in the virtual meltdown of financial services here and in Europe causing huge layoffs among groups new to being laid off. The actual and threatened collapse of large financial institutions, combined with the plunge in U.S. house prices, led to long employment lapses in services and construction as well as huge losses in stock and bond markets. This combination brought such a level of fear about one's immediate and long-term future that it is not surprising that consumer spending growth plummeted as households faced a loss of income and the financial basis for retirement.

Job losses are now greater in levels and percentages than any recession since the 1930s. This has led to a new conservatism where consumers are saving more, paying down debt and being much more selective in their purchases. Even though financial asset prices have recovered from pre-crisis levels and business profits and productivity have brought a recession trough, the rebirth of consumer confidence has been very slow. Solid job prospects are critical to confidence, which is the key for consumer spending that generates 71% of all U.S. economic activity.

So where does employment go from here? Leading indicators of job growth have mostly turned positive.

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Over 50,000 jobs for temporary workers were added in November, the fourth straight month of increases. Revisions to prior payroll reports were also very positive. Employment in the Household Survey rose by 227,000. Jobless claims in December took a big tumble and are now down to levels that in the past have been consistent with moderate job gains. The American Staffing Association index of temporary help rose over a year ago in recent weeks for the first time several quarters. While the recovery is still tenuous, we believe the job trend is now up and that the gains will be better than many expect. We base this on the strength in corporate profits, growth in industrial output, gains in capital spending and persistent improvement in financial markets. Our projections are as follows:

- An average unemployment rate of 9.3% in 2009, 9.8% in 2010 and 9.3% or less in 2011.
- The unemployment rate likely peaked at 10.2%, but will remain at or near present levels during the first half of 2010 before falling to 9.5% or so at year end and 7.8% by the end of 2011.
- We assume a gradual increase in the labor force participation rate to 65.5% at year end 2010 (up from 65.0%) and 66.0% at year end 2011 along with employment growth of 150,00 in January growing to 350,000 in December and averaging 400,000 per month in 2011.

Are gains of that size realistic? While they are a sharp improvement over recent years, they are well in line with historical experience. Monthly job growth as a percent of the labor force should reach 0.16% by December and 0.25% in late 2011. By way of comparison, in 1983 monthly employment growth was higher, ranging between 0.3% and 0.4% of the labor force. In the rebound from the 1975 recession, employment growth per month exceeded 0.2% of the labor force for more than two years. After the mild 1991 recession, employment growth was more subdued, but still reached levels above 0.2%. The exception was the 2001 recession where employment growth never exceeded 0.2% of the labor force per month for the entire decade!

There is certainly downside risk to this above consensus forecast. But given that businesses likely shed too many jobs during the panic of the credit crunch, the combination of a sharp rebound in profits, ongoing monetary stimulus and the historical precedent of past recoveries could lead to job growth being better than many believe.

It Could Have Been Much Worse

By early March with credit markets still choked, the U.S. Federal Reserve (Fed) lowering interest rates at and between meetings, U.S. stocks collapsing 25% or so, jobs being lost by the hundreds of thousands and world Gross Domestic Product plunging, ending the year with positive equity returns seemed like a pipe dream. And yet the S&P 500 Index rose 23.4% for the year and 64.8% from the low on March 9, 2009. Investors had become intensely risk averse in the prior nine months selling everything but gold, U.S. dollars and U.S. Treasuries. Pessimism reached its peak, though, in March when an equity rally began that persisted with little interruption through year end.

That rally was a harbinger of U.S. economic recovery as the best performing sectors were those associated with economic strength, i.e., technology, basic materials and consumer discretionary stocks, up 59.5%, 45.4% and 38.8% respectively for the year. Global economic recovery was also foreshadowed by the MSCI GICS (Morgan Stanley Capital International Global Industry Classification Standard) indices with strong returns in 2009 by basic materials, up 72.2%, technology, up 48.5%, energy, up 45.1% and consumer discretionary stocks, up 42.4%. Emerging market stocks are also highly leveraged to global growth and 2009 returns were terrific with the MSCI Emerging Market Index up 74.5% for the year. Broad indices soared in China, up 80.0%, Russia, up 121.1%, Brazil, up 82.7%, India, up 81.0%, Thailand, up 63.2%, Taiwan, up 78.3%, Hong Kong, up 52.0% and Chile, up 50.7%.

Performance in the fourth quarter showed the rally might be maturing somewhat. Some sectors sensitive to economic growth continued to outperform: e.g., technology, materials and consumer goods in the

United States as well as materials and energy in global indices. But outperformance began to rotate to more defensive sectors; health care and utilities in the United States and consumer staples and health care globally. U.S. growth stocks had better returns than value stocks and U.S. large-cap stocks outperformed those with lower market caps.

Gains in U.S. credit markets were also outstanding in 2009. Bond prices actually troughed and credit spreads hit their widest levels in late November 2008; corporate credit markets improved in January as bond issuance began to find good demand from investors. Commercial paper markets opened up first followed by investment grade and then high yield. Investors became much less averse to risk as 2009 progressed and yields on riskier bonds fell as prices rose. For example, the Barclays Capital U.S. Corporate High Yield Index* gained 58.2% for the year but the big returns went to the lower-rated bonds. The higher BB-rated part of the index gained 46.1%; the lower CC-rated bonds returned 90.6%, but the single-C rated bonds gained 136.3%.

If the global economy continues its recovery as we expect, equity markets should see further gains in 2010, although the easy part of the move is surely over. There will likely be more volatility and downside risks as world central banks prepare to remove some of the massive monetary stimulus put in place over the past 16 months. Nevertheless, the recovery is in its early stages and we still like those sectors and indices that are leveraged to economic growth. Industrialization and urbanization in emerging markets has a long way to go. Fast gains in productivity in those countries will lead to strong income growth and portends healthy consumer demand in Asia, Latin America and hopefully Eastern Europe. This is part of the economic rebalancing process that needs to be underway around the world.

The U.S. Economy

The trajectory of U.S. economic growth has not yet matched the gains of the stock market but a revival is clearly underway. The worst recession since World War II probably became history by August or so of 2009. The gigantic annualized GDP plunge of -6.4% in the first quarter was followed by a 'flattish' second quarter

(-0.7%) with 2.2% growth beginning in the third quarter. All consumer and business components of GDP detracted from growth in the first half; only net exports and government spending added to growth. Decent consumer spending buoyed by the "Cash for Clunkers" auto stimulus gave a boost to the third quarter, but investment in equipment, software and housing also rose.

We expect the economy showed more life in the fourth quarter with a 4.5% gain and will be followed by equally strong gains in the first quarter of 2010. Growth may slow some the rest of the year but we expect a full year 2010 gain of 3.3%. This is weaker than expected following a major recession, but strong enough to show job growth and bring further gains to the stock market. There are several forces impacting the U.S. economy that provide the foundation to our forecast: an inventory cycle, good profits, modest consumer spending, a synchronized global recovery and low inflation.

Inventories: Facing headwinds of record gas prices, rising interest rates and collapsing house prices, U.S. consumers had already begun to cut spending in the summer of 2008. In the panic aftermath of the Lehman bankruptcy, businesses responded to plunging sales and collapsing credit availability by slashing payrolls, capital spending and especially production. As a result, sales came out of inventory rather than new output and inventories in the GDP accounts plummeted at increasing record rates in the first and second quarters of 2009 and at an even faster rate ex autos in the third quarter. So by October, Old Mother Hubbard's Cupboard was bare and production had to rise just to meet current demand or sales would fall from lack of goods.

Economic growth only comes from new output; sales made from inventory don't count. Rising production means more jobs, hours and income, which leads to more spending, sales and profits and induces companies to boost output further. That virtuous circle is the foundation of an economic expansion and is what we hope is underway. We expect less inventory liquidation plus restocking to add 2.7% to U.S. growth in the fourth quarter and 1.2% in 2010.

² The U.S. Corporate High-Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes Emerging Markets debt.

Strong Profits: Profit is the source, the wellspring for economic progress, jobs and investment. Without earnings, companies will not hire or expand; falling profits bring layoffs, cutbacks, salary reductions and a shrinking economy. Politicians who lambast profits for populist appeal misunderstand the nature of economic growth; output has to be created before it can be distributed. Profit is the signal for businesses to expand production and provides the incentive to do so.

Reported U.S. profit growth has been outstanding so far in 2009. Profits were excellent in the second quarter and soared 10.8% in the third quarter, more than a 50% annual rate. With another such report in the fourth quarter, business profits would reach a new record. Productivity growth is the key source of those profits. Output per hour rose at over a 7% annual rate in the second and third quarter; unit labor costs have fallen about 3% or so over the prior year through the third quarter. There has never been a time when a profitable business sector did not hire workers and purchase capital equipment. These profits bode well for further economic growth and reinforce the recovery.

Modest Consumer Spending: Faced with high debt, rising interest costs and gas prices and falling net worth, U.S. consumers had already begun to pare spending growth in early 2007 well before the recession actually started. Consumer purchases plunged in the second half of 2008 at a 3.3% annual rate, the worst two-quarter collapse since the first half of 1980. Chastened by home foreclosures, layoffs, salary reductions and rising debt payments, consumers raised their saving rate to 4.7% currently from just above zero a year or two ago. Further debt reduction is likely and, while employment is about to increase, unemployment will be slow to fall; so we expect consumer spending growth in 2010 to be 1.6%, i.e., modest but positive.

Synchronized Global Recovery: An extreme credit market seizure was triggered by events surrounding the Lehman bankruptcy. The resulting credit crunch transmitted what was initially a financial crisis to the real economy and the Great Recession was born. Synchronized, aggressive and massive central bank intervention around the world restored confidence to the

financial system, helped make credit available once again and provided the financial foundation for recovery.

As a result, the United States is not alone in economic recovery, nor is it even the leader. The Chinese economy grew nearly 10% in 2009 and we believe it is likely to perform almost as well in 2010. That strength helped lift the rest of Asia out of recession and is the destination for exports from the United States and Latin America as well. Australia avoided recession with only one down quarter. The Euro area probably exited recession last summer. The U.K. economy contracted slightly in the third quarter but should expand in the fourth. Brazil, Russia, India, and Indonesia are all growing rapidly as are Hong Kong, South Korea, Taiwan and Singapore. This widespread progress feeds on itself and is supportive of further growth.

Low Inflation: U.S. core inflation, ex food and energy, will be 1.5% in 2009 and will likely decline further in 2010, perhaps even below 0.5% on a year-over-year basis. Explicit and implicit rent, a measure of housing expense, comprises almost 40% of the measure of core inflation and is deflating fast. Goods prices are likely still falling or are flat at worst. Overall prices are deflating in Japan and inflation is still well under control in the Euro area.

With little inflation on the horizon, the Fed will be under no pressure to raise interest rates in the near future. Monetary policy can stay accommodative for the proverbial "extended period," and remain quite supportive of further economic growth. We do expect the Fed to move away from its emergency Fed Funds range of 0.0% to 0.25% in the middle of 2010; but even a year-end rate of 1.0% would still be extremely accommodative. The five forces described above are interacting to promote the moderate U.S. recovery that we are forecasting. Hopefully, by the fourth quarter of 2010, confidence will have returned and the virtuous circle will have become entrenched so the dreaded double-dip that some pundits prognosticate will be left in the dust of an enduring expansion. There are still significant risks to the economy: drastically higher taxes, overly stringent re-regulation, a Fed restricted by politics, further home foreclosures, a struggling commercial real estate sector, expanding government debt, potential inflation and an end to monetary stimulus that is either too fast or too slow.

For now, though, we hope to just live the expansion for at least a quarter or two. Current and expected U.S. data are shown in the summary below and in the attached tables.

Forecast Table	2008(A)	2009(E)	2010(E)
Real GDP	+0.4%	-2.5%	+3.3%
Domestic Final Sales	-0.4%	-2.7%	+1.8%
U.S. Auto Sales (units)	13.7M (-15.2%)	10.5M (-23.1%)	12.1M (+15.0%)
Industrial Production	-2.3%	-9.5%	+4.2%
Housing Starts	906,000 (-33.1%)	556,000 (-38.6%)	775,000 (+39.4%)
After-Tax Corporate Profits (National Income and Products Accounts Basis through Q4 2008)	-11.5%	0.3%	+25.0%
Federal Budget Balance (Fiscal Years)	-\$454.8B	-\$1.4T (that's a T!)	-\$1.1T
Civilian Unemployment Rate	5.8%	9.3%	9.8%
Consumer Price Index – Overall	+3.8%	-0.3%	+1.5%
Consumer Price Index – ex Food & Energy	+2.3%	+1.7%	+1.0%
GDP Price Index	+2.1%	+1.3%	+1.0%

A – Actual E – Estimated

U.S. Interest Rate Outlook

While past highs and lows along with the recent trend in interest rates is captured in the following table, the real question where are rates headed. We believe rates will move higher this year with some flattening of the yield curve from its current extremely steep slope. This view is based on the following:

- Significant economic growth during the fourth of 2009 and throughout 2010 including back-to-back quarters of 4.5% real GDP increases in the fourth quarter of 2009 and first quarter of 2010
- A resumption in employment growth and a gradual reduction in the unemployment rate
- Increases in oil and commodity prices to at least raise the possibility of higher inflation
- The Fed increasingly likely to start raising interest rates either at mid year or soon thereafter

Interest Rates	12/31/2006	12/31/2007	12/31/2008	6/23/2009 (High)*	1/14/2008 (Low)*	12/31/2009 Current
2-year	4.81%	3.05%	0.76%	1.36%	0.71%	1.14%
10-year	4.70%	4.02%	2.21%	3.95%	2.20%	3.84%
10-2 spread	-0.11%	0.97%	1.45%	2.59%	1.49%	2.70%

*Based on the 10-year U.S. Treasury bond, over the previous 12 months.

Fed decisions will be the most likely guide for rates in 2010. Even though inflation is not presently an issue and there is a lot of slack in the labor force and productive capacity, the outlook for growth is sufficiently strong that the Fed should move away from its zero policy rate during 2010 with one or two rate increases by year-end. The Fed will not necessarily move ahead of financial markets, but will rather be putting short rates at a level more in line with market expectations as growth momentum accumulates during the year.

Given these factors, our expectation for U.S. interest rates at year end 2010 is as follows:

Federal Funds Rate Target	1.00%
10-year Treasury Rate	4.50%
2-year Treasury Rate	2.25%
2-10 year curve slope	2.25%

We feel the Fed will begin preparing financial markets for a rate increase during the second quarter. Less certain is the timing of the initial rate increase. It could be at their June Federal Open Market Committee meeting or later in the year depending on economic conditions. We are, however, confident that there will be no rate hike before mid-year.

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