ALTERNATIVES

Global Economic Perspective: January

January 15, 2016

Perspective from Franklin Templeton Fixed Income Group®

US Fundamentals Look Strong Enough to Cope with Higher Rates

We see 2016 as likely providing another period of modest-to-moderate US growth, similar to recent years, even as the US Federal Reserve (Fed) continues to nudge policy rates higher. The extent to which labor-market tightness translates into wage growth and stokes inflation as the year unfolds remains a key consideration.

A Softer Growth Backdrop for Much of the Rest of the World

The potential for further US rate rises along with China's slowdown may have increased uncertainty, but while the rest of the world may not be doing as well as the United States, we think global growth remains acceptable and do not anticipate a global recession or global deflation.

Europe’s Recovery Remains Modest but Inflation Still Weak

We expect conditions in the eurozone to remain broadly similar for some months to come, with steady, if modest, growth. The European Central Bank’s (ECB’s) future policy will continue to be directed toward improving the weak inflation outlook, and we would expect the central bank to respond proportionately to changes in regional or global conditions.

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US Fundamentals Look Strong Enough to Cope with Higher Rates

Bond markets showed little reaction to December’s well-telegraphed move by the Fed to increase US policy rates for the first time in nearly a decade. Nevertheless, the significance of the Fed’s shift to a more normalized monetary policy and its implications about the state of the US economy were not to be underestimated. For consumers and corporations, the change to an environment of rising rates emphasized the extent of the US recovery from the global financial crisis; for investors, it potentially signified the onset of a more familiar monetary cycle, following an extended period of extraordinary measures by the Fed, including quantitative easing (QE) and near-zero policy rates.

At its December meeting, the Fed also maintained its projections for the pace of future rate rises in 2016, estimating that rates could rise by another 100 basis points by the end of the year. Policymakers’ outlook was somewhat at odds with the slower pace forecast by market consensus, possibly as a result of some analysts’ predictions that fourth-quarter gross domestic product (GDP) growth would prove a touch disappointing. But the Fed also underlined that it would determine the timing and size of future moves by assessing “realized and expected” economic conditions relative to its employment and inflation goals. With the Fed’s median estimate for the longer-term federal funds rate unchanged at 3.5%, this latest tightening cycle, at its outset anyway, still seemed likely to be more restrained than most previous eras of tighter monetary policy.

Attention quickly shifted to how the US economy would absorb higher rates. The labor market maintained its strong momentum in December, with the figure of 292,000 additional jobs considerably ahead of consensus expectations, and a significant upward revision to the November total as well. Further evidence of the key driver of the economy’s recovery—the positive backdrop provided by the capacity of US consumers to spend and their resilience to external shocks—was not hard to find. Retail sales data for November showed a very solid 0.5% expansion excluding vehicles and gasoline, hinting at healthy sales on Black Friday. Though the rise of online retailers has made holiday sales data harder to interpret, some indicators pointed to a further pickup in transactions late in December and into the new year. Surveys of consumer confidence in December were strong, with the University of Michigan index climbing to its highest level since July. Housing provided another bright spot, after the S&P/Case-Shiller 20-City Home Price Index increased more than expected in October, rising at its fastest pace since August 2014. Housing starts and permits data for November also beat consensus expectations, although there was a dip in existing-home sales over the same period that probably related to new mortgage requirements.

After rising against most other major currencies for three straight months ahead of the Fed's decision, the US dollar lost ground in thin holiday trading during the following weeks, eventually having its worst monthly performance in December since the previous April. However, the prior strength of the currency probably contributed to ongoing weakness in a US manufacturing sector beset by import price deflation and price competition. A second successive weak reading came in from the Institute for Supply Management's (ISM's) manufacturing purchasing managers' index (PMI), which in December fell well below the 50 mark that separates expansion from contraction. The index dropped to its lowest level since July 2009, underlining the softness of foreign demand that has hurt many US exporters. The ISM's measure for customer inventories ticked higher during the month, in a reminder of the likely headwind from inventories for the economy in the fourth quarter. However, trade data for November revealed a smaller deficit, possibly providing a small offsetting boost to GDP.

Readings for inflation generally remained benign, with November's Consumer Price Index showing headline inflation flat on the month and up 0.5% year-on-year (y/y) and core inflation up 0.2% month-on-month and 2.0% y/y. Weak energy prices continued to bear down on the headline figure, while services inflation was again offset by falling goods prices. Similar trends were evident in November data for the Fed's preferred measure of inflation, core personal consumer expenditures, which showed a 0.1% rise on the month and 1.3% y/y. The backdrop for corporations varied across sectors: In terms of pricing power, service providers—for example, in health care—maintained their ability to push through price increases, while more broadly, many areas benefited from lower input costs following the decline in energy prices.

We see 2016 as likely providing another period of modest-to-moderate US growth, similar to recent years, even as the Fed continues to nudge policy rates higher. Consumers should see further benefit from a tighter labor market, their finances and spending power already having been bolstered by previous rises in equity and real estate markets. The extent to which labor-market tightness translates into wage growth and stokes inflation remains a key consideration as the year unfolds. For corporations, the ongoing headwinds posed by a stronger US dollar and weaker export markets should be offset, in our opinion, by a potential boost from lower input prices.

A Softer Growth Backdrop for Much of the Rest of the World

The contrast in the economic and monetary outlook between the United States and much of the rest of the world was underlined by comments late in December from International Monetary Fund (IMF) Managing Director Christine Lagarde. The IMF head predicted a disappointing year ahead for global economic growth, with further rises in US interest rates and a slowing Chinese economy contributing to uncertainty and a higher risk of economic vulnerability worldwide.

Events at the start of the year provided backing for the IMF’s viewpoint. Oil prices were volatile on rising geopolitical tensions in the Middle East, as relations between Saudi Arabia and Iran, the two most powerful members of the Organization of the Petroleum Exporting Countries (OPEC), deteriorated sharply. With the prospect of any agreement on curbs to OPEC production fading, oil prices fell to their lowest level in more than a decade. The fallout for countries largely dependent on energy production for revenues was exemplified by Russia, where an economy also hurt by Western sanctions was widely predicted to contract sharply in 2016 for the second successive year. The Russian ruble reacted to the further slide in oil prices by falling to its weakest level against the US dollar on record, apart from a brief rout in December 2014.

As alluded to by the IMF, uncertainty about the extent of a slowdown in Chinese growth and the likely response of Chinese authorities remained at the forefront of concerns for many global investors. The impact of these worries was apparent not just in commodity markets, but more broadly across risk assets. Gyrations in the Chinese stock market—which was repeatedly shuttered after reaching its daily limit for declines—and an ongoing depreciation of the Chinese renminbi spooked global stock markets. We also saw a boost in demand for those highly rated sovereign bonds traditionally seen as havens in times of market volatility.

The difficulty of interpreting developments in the Chinese economy complicates evaluation not just of the overall global economy, but more specifically of those countries whose growth is heavily influenced by the Middle Kingdom. While we maintain our view that fears of a Chinese “hard landing” are overblown, the lack of clarity about the way in which the Chinese government might deal with rebalancing the engines of the country’s economic growth—potentially leading to further renminbi depreciation—is likely to continue to unsettle markets. Such a backdrop could increase pressure on countries for whom China is a key market.

But, rather than focusing too much on the negatives, we believe it is important to adopt a balanced approach that also considers the positive aspects of the current outlook. Cheaper energy prices should provide a medium-term boost to global growth, as well as help contain inflation in countries where consumer demand is picking up. Concerns of a systemic crisis among emerging markets look to have been exaggerated, as there are significant differences across the asset class. Most commodity exporters, and emerging markets with poor macro fundamentals, remain vulnerable. Other emerging countries, however, have solid policies and better underlying fundamentals that have not been recognized by market valuations. Though the rest of the world may not be doing as well as the United States, we think global growth remains acceptable and do not anticipate a global recession or global deflation.

Europe’s Recovery Remains Modest but Inflation Still Weak

European data continued to indicate a steady, if modest, recovery across the region, coupled with extremely low inflation. Markit's eurozone manufacturing PMI rose in December to its highest level since April 2014, while an ongoing recovery in the labor market saw eurozone unemployment fall in November to its lowest level in more than four years. Spain and Italy saw the sharpest declines in workers seeking employment, from 23.7% to 21.4% and from 13.1% to 11.3%, respectively. Less encouraging was a third successive monthly fall in eurozone retail sales in November, though the data still registered a 1.4% rise compared with 12 months earlier.

Inflation for the region also came in lower than consensus expectations in December, with headline inflation at 0.2% y/y and a core figure of 0.9% y/y, bringing into question the ECB's forecast of a headline level of 1.0% for the whole of 2016. The weak numbers immediately sparked debate about the possibility of further QE by the ECB in order to get inflation back to its target of just under 2%, following its previous easing of monetary policy in December.

Political risk also came into focus after the Spanish election in December delivered a fragmented result, followed by inconclusive talks to form a governing coalition that seemed most likely to lead to fresh elections being scheduled. The outcome in Spain mirrored the trend of disenchanted voters throwing out incumbent parties that has been seen in many other eurozone countries, and of populist parties skeptical about the merits of eurozone membership gaining ground. Nevertheless, after a brief spike in Spanish government bond yields immediately after the election results, volatility quickly subsided.

Looking ahead, we expect conditions in the eurozone to remain broadly similar for some months to come. While there may be some upside risk to growth estimates, expansion of around 1%–1.5% seems a more likely scenario, in our view. The ECB's future policy will continue to be directed toward improving the weak inflation outlook, and in this regard, we would expect the central bank to respond proportionately to changes in regional or global economic conditions.

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