EMERGING MARKETS

Global Economic Perspective: December

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Perspective from Franklin Templeton Fixed Income Group®

US Election Result Moves Markets and Fed Raises Rates As Expected

The prospect of a Donald Trump presidency has produced some sharp moves in global financial markets, as speculation about the introduction of a potentially sizable fiscal stimulus has caused investors to reassess their outlook. Upbeat economic data have fostered a positive backdrop, and, as expected, the US Federal Reserve (Fed) raised interest rates at its December meeting. However, we feel some caution may be required before assuming that a more expansionary fiscal approach by the new administration will quickly translate into a sustainably higher growth rate for the US economy.

Emerging Markets Hit By Rising US Yields and Strong Dollar

The combination of higher US Treasury yields and a stronger US dollar has increased pressure on emerging-market assets. Though emerging-market assets have been among the biggest losers in the aftermath of the US election, we would argue that some of the moves have been exaggerated. With details of the new US administration's policies yet to be determined, the indiscriminate selloff seems to us to ignore the solid growth and debt fundamentals of certain countries.

ECB Extends Timeframe for Monetary Easing Following Italian Referendum Result

Following the result of Italy's constitutional referendum, Europe's political environment appears set to remain uncertain throughout most of 2017 and potentially well beyond, with elections in many of the most important countries and the likely start of negotiations on the terms of the United Kingdom's exit from the European Union. Against this backdrop, we think the European Central Bank (ECB) has acted sensibly in choosing to extend its bond-purchasing program, even at a reduced level, rather than announcing a timetable for its cessation, which should help minimize the risk of creating an upsurge in market volatility.

US Election Result Moves Markets and Fed Raises Rates As Expected

The prospect of a Trump presidency has produced some sharp moves in global financial markets, as speculation about the introduction of a potentially sizable fiscal stimulus has caused investors to reassess their outlook for growth, inflation and interest rates in the United States. Upbeat economic data have fostered a positive backdrop, and investor confidence has been enhanced by the incoming administration's orderly approach to the transition of the presidency. As expected, at its December meeting the Fed reacted to the improved data by raising interest rates, only the second such increase in a decade.

However, we feel some caution may be required before assuming that a more expansionary fiscal approach by the new administration will quickly translate into a sustainably higher growth rate for the US economy. While the US corporate sector could benefit from future tax cuts, it may suffer if other policies are introduced that restrict trade or immigration. In order to meaningfully improve the US trend growth rate from its post-financial crisis level of around 2%, comprehensive legislation—with a particular focus on improving the skills base of the US labor force to address low productivity—will probably be needed, and reaching the political consensus necessary to enact such measures could be extremely hard to achieve.

During November, an upward revision of third-quarter 2016 gross domestic product (GDP) was among the most eye-catching pieces of data, with growth marked up from 2.9% to 3.2%. The main factor driving the increase was consumer spending, which was estimated to have risen by 2.8% during the quarter, compared with a prior estimate of 2.1%. Given that the initial GDP reading had been heavily influenced by temporary factors such as soybean exports and inventory restocking, the higher contribution from US consumers was viewed positively as broadening the composition of growth.

Though October's consumption spending data came in below consensus expectations, the buoyancy of consumers was underlined by The Conference Board's survey for November, which showed consumer confidence at its highest level since July 2007. There were also early indications that holiday season retail sales had gotten off to a solid start, with some surveys suggesting increased demand for high-end items, as wealthier consumers anticipated tax cuts.

November saw a further 178,000 jobs added across the US economy, broadly in line with consensus expectations, but other aspects of the monthly labor market report were more noteworthy. A sharp dip in the unemployment rate, by 0.3% to 4.6%, represented the lowest reading since August 2007, but it was largely explained by another drop in the labor force participation rate, which remained soft. Following October's strong wage gains, the data for November failed to match expectations, with average hourly earnings falling by 0.1% from the previous month, reducing the annual gain from 2.8% to 2.5%.

The trend of subdued inflationary pressures continued in the monthly inflation data. October's core personal consumption expenditures (PCE) price index was static at 0.1% month-on-month and 1.7% year-on-year, though higher energy prices did boost the headline PCE index to an annual rate of 1.4%, a two-year high. But in keeping with the moves seen in other markets following the US election result, inflation expectations rose sharply, pushing the market indicator for US inflation over the next 10 years up to levels last seen in 2014.

The latest Institute for Supply Management purchasing managers' indexes (PMIs) for manufacturing and services provided further positive news on the economy. The manufacturing composite PMI accelerated to 53.2 in November, with the measure for production particularly robust, and echoed the stronger trend seen in other regional manufacturing surveys, such as one published by the Federal Reserve Bank of Philadelphia. For the same month, the services PMI came in ahead of consensus forecasts at 57.2, the highest level since October 2015, while the business-activity component of the index covering this dominant area of the economy bounded ahead with a reading of 61.7.

After parsing the strong data, market participants had already decided the Fed was all but certain to raise interest rates before the end of 2016, and the central bank duly announced this move at its December meeting. Fed policymakers also indicated their expectations for a further pickup in growth by signaling three potential rate hikes in 2017, a faster pace than in previous estimates. Though the post-election rise in Treasury yields and the US dollar effectively meant that monetary conditions had already tightened, a leading Fed official stated it was important to distinguish between a tightening caused by a spike in risk aversion—such as the one at the start of 2016—and one arising from an improving economy, which was a natural occurrence to be expected.

We believe the recent correction in the Treasury market was indeed partly an overdue normalization reflecting the solid underlying fundamentals of the US economy. The move follows an extended period when a weak global backdrop and the related monetary easing by other central banks around the world had artificially depressed yields. The potential for a more expansionary fiscal stance also likely accounts for some of the Treasury selloff, but we are less confident about attributing a greater significance to projections of sharply higher US growth. Given the advanced stage of the cycle the US economy has already reached, uncovering sources of additional demand could be a tough undertaking.

Emerging Markets Hit By Rising US Yields and Strong Dollar

The combination of higher US Treasury yields and a stronger US dollar has increased pressure on emerging-market assets. The widespread weakness of emerging-market currencies against the surging US dollar was described by many market participants as similar to the “taper tantrum” of mid-2013, which followed the Fed’s announcement of a tapering of its quantitative easing program. By late-November, the Chinese renminbi had slumped to its lowest point against the US currency in eight years.

Though emerging-market assets have been among the biggest losers in the aftermath of the US election, we would argue that some of the moves have been exaggerated. With details of the new US administration’s policies yet to be determined, the indiscriminate selloff that has hit countries like Poland—where benchmark yields have risen around 1% in a month—seems to us to ignore the solid growth and debt fundamentals of certain countries.

Even though the Indian rupee fell to an all-time low against the US dollar during the month, Indian government bonds moved in the opposite direction, following the announcement by the country’s government at the start of November of a withdrawal (“demonetization”) of more than 85% of the existing banknotes in circulation. The decision by the Indian authorities was intended to crack down on tax evasion in a country where nearly all consumer payments are made in cash. As people handed over their cash, banks swiftly re-invested the proceeds into the bond market, driving down benchmark Indian government bond yields by more than half a point, to their lowest level in seven years. Amid concerns lower interest rates might spur inflation, the Reserve Bank of India announced lenders would be required to deposit any cash accumulated through the demonetization at the central bank.

China’s foreign-exchange reserves fell in November for the fifth consecutive month—although they remained above US$3 trillion—as Chinese authorities introduced a new set of measures to curb capital outflows, including restrictions on overseas investments by Chinese companies. Capital outflows from China have been calculated by the Institute of International Finance as totaling US$530 billion for the first 10 months of 2016, and net monthly outflows from the country have been occurring continuously since the start of 2014.

Elsewhere in Asia, preliminary figures showed the Japanese economy grew by an annualized 2.2% during the third quarter, much faster than generally expected, although the initial reading for the country’s GDP has often been prone to significant revisions. Nearly all of the growth came from trade, suggesting the country’s exporters had coped well with the strength of the Japanese yen during the quarter. However, judgments about the momentum of the Japanese economy were complicated by the subsequent adoption of new international accounting standards, which reduced the third-quarter figure to 1.3%, even though there were also significant upward revisions to data for previous years.

The rally in US Treasury yields was given another boost by news that members of the Organization of the Petroleum Exporting Countries (OPEC) had reached agreement on the implementation of production cuts, which had been first mooted in September. Several other producers that are not part of OPEC also promised to reduce their output. The deal confounded earlier skepticism among many market participants and pushed oil prices up to their highest level since mid-2015. Most other commodity prices also moved higher, as investors decided demand for materials was likely to increase following the US election result.

ECB Extends Timeframe for Monetary Easing Following Italian Referendum Result

The main political event in Europe during recent weeks was an Italian referendum at the start of December to decide on changes to the country's constitution proposed by the government. The subsequent rejection of the proposals by voters delivered a resounding defeat for Italian Prime Minister Matteo Renzi, who had staked his authority on the measures gaining approval. Following Prime Minister Renzi's resignation, Italy's foreign minister, Paolo Gentiloni, was quickly installed as his replacement, with most of the other members of the government retaining their posts. Even though reaction across European markets to the referendum's outcome was muted, the swift move to appoint a new head of government was partly aimed at minimizing political instability, which could have further complicated attempts to recapitalize one of Italy's largest banks and risked adding to the weak condition of much of the country's banking sector.

The result also served to increase focus on the potential for future political protest votes in Europe. The possibility of a victory for the right-wing candidate Marine Le Pen in next year's French presidential election drew particular attention, though her lack of support in the French parliament appeared to limit the potential for any immediate radical shift in policies resulting from such an upset. Elsewhere, in a rare reversal of the populist tide that has swept through European politics, Austria's re-run presidential election saw the right-wing candidate defeated by his centrist opponent.

Spain's newly formed minority government unveiled plans for a tighter fiscal approach to tackle the country's sizable budget deficit, which has widened beyond the level permitted by the European Commission (EC) and has increased the threat of financial sanctions. The government plans to raise additional revenue mainly by closing corporate tax loopholes, and it hopes to bring the deficit down to 3.1% of GDP by 2017, as agreed with EC officials. In order to gain parliamentary approval for the fiscal package, the conservative government also included less restrictive measures designed to win cross-party support, such as an increase in the country's minimum wage.

Data covering October showed Spain's unemployment rate fell below 20% for the first time in six years, highlighting the extent of the country's economic recovery, even though the Spanish government's latest forecasts predict a slowdown from 3.2% growth in the current year to 2.5% in 2017. Indeed, the employment picture across the 28-country European Union as a whole has markedly improved, with October's jobless rate falling to 8.3%, the lowest level since 2009.

As expected, at its December meeting the ECB announced an extension of its monetary easing program, which had previously been scheduled to end in March 2017, and pledged to maintain the program until at least the end of 2017. The central bank also reduced the size of its monthly purchases from €80 billion to €60 billion, though ECB officials rejected suggestions this represented a tapering of its program, arguing that the total number of bonds purchased could actually increase. The ECB also revealed a new set of growth and inflation forecasts for the eurozone, predicting for the first time inflation would remain below the bank's 2% target till at least 2019. Market measures of inflationary expectations in the single-currency bloc had increased ahead of the ECB's widely anticipated move to extend its monetary stimulus, with the predicted rate for five years' time reaching its highest level so far in 2016, though this was still only around 1.7%.

Europe's political environment appears set to remain uncertain throughout most of 2017 and potentially well beyond, with elections in many of the most important countries and the likely start of negotiations on the terms of the United Kingdom's exit from the European Union. Following the UK vote in June, political risk is now being discounted by market participants, as further victories for insurgent populist candidates now seem a realistic possibility, and it was notable how the outcome of Italy's vote created relatively little market volatility. Against this backdrop, we think the ECB has acted sensibly in choosing to extend its bond-purchasing program, even at a reduced level, rather than announcing a timetable for its cessation. Such a move should help minimize the risk of creating an upsurge in market volatility, in our assessment, not least with a view to maintaining the stable conditions needed to restore confidence in the Italian banking sector.

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