EMERGING MARKETS

# Global Economic Perspective: January

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**Perspective from Franklin Templeton Fixed Income Group®**

**Solid Economic Backdrop Awaits New US Administration**

As Donald Trump's inauguration as US president approaches, the fundamental backdrop for the US economy appears healthy, with moderate growth, inflation seemingly contained, and both consumer and corporate indicators looking mostly positive. Despite widespread expectations the incoming administration might initiate significant changes that could speedily boost growth, we feel such hopes may have run a little ahead of actual events and could be tilted to the upside. In the meantime, looking out into 2017, we remain cautiously optimistic the economy is likely to maintain its steady upward trajectory.

**Confidence Picks Up Across Global Economy, Helped By Rising Commodities**

Although overall activity levels and confidence have improved, the global economic environment continues to be somewhat challenging, and we feel the backdrop of slow-but-steady global growth is likely to remain fundamentally unaltered. Markets may have already discounted positive expectations of the measures politicians are able to deliver, which could create further volatility if these hopes prove elevated compared to reality. Geopolitics could provide another source of market unease, as the potential for frictions arising from new political and trading alignments seems to us to have markedly increased.

**Inflation Rises Ahead Of Crowded European Political Calendar**

European economic conditions have continued to slowly improve, as the European Central Bank's (ECB's) monetary easing has further underpinned the region's halting recovery. The question remains whether this progress can be maintained in the face of any further political shocks. Forthcoming elections could limit the power of leading policymakers, and further challenges may emerge over Europe's relations with the new US administration, as well as over the United Kingdom's Brexit negotiations. Although we are cognizant of the potential for such setbacks to temporarily hurt business and consumer confidence, our view is that the ECB's accommodative stance should continue to support a reasonable, if unspectacular, level of economic activity.

**Solid Economic Backdrop Awaits New US Administration**

As Donald Trump's inauguration as US president approaches, it is important to remember that the economic picture since the election result has remained broadly the same. The fundamental backdrop for the US economy appears healthy, with moderate growth, inflation seemingly contained, and both consumer and corporate indicators looking mostly positive. Despite widespread expectations the incoming administration might initiate significant changes that could speedily boost growth, we feel such hopes may have run a little ahead of actual events and could be tilted to the upside. Opportunities surely exist for structural reforms, but in our view they might take time to be implemented and come to fruition. In the meantime, looking out into 2017, we remain cautiously optimistic the US economy is likely to maintain its steady upward trajectory.

Economic releases generally remained upbeat as 2016 drew to a close and the new year began. Measures of sentiment underlined the surge in confidence among US consumers and corporations following Trump's surprise election victory. As broad stock market gauges reached record levels, a December survey of US consumer sentiment compiled by the University of Michigan hit its highest point since before the global financial crisis of 2008-2009. A survey of optimism among smaller companies showed a similar spike following the election, illustrating the hopes of small business owners for a friendlier regulatory environment under the new administration.

Among larger companies, a quarterly poll of chief financial officers (CFOs) measuring optimism about the US economy rose from 60.6 in September to 66.5 in December, while the percentage of those respondents feeling more optimistic about the US economy had increased from 26.7% to 64.1%. However, the survey suggested CFOs' expectations for a pickup in capital expenditure remained muted, despite some conjecture about the potential introduction of tax breaks to boost business investment, possibly by enabling companies to repatriate overseas earnings at a favorable rate.

Other positive signs from the corporate sector included the December reading of the Institute for Supply Management (ISM) purchasing managers' index (PMI) for manufacturing, which climbed to a two-year high of 54.7. The strength in the composite index was reinforced by the robust performance of subcomponents like new orders, export orders, production and prices. A similarly constructive tone applied to the December ISM PMI reading for the services side of the economy, which remained at the highest level for 2016 established in the previous month, with new orders and business activity the main hotspots.

December's labor market report showed 156,000 jobs had been added during the month, a little shy of consensus expectations, although this was broadly offset by an upward revision to previous months' data. The unemployment rate ticked up by 0.1% to 4.7%, largely as a result of an increase in the size of the labor force, while the labor force participation rate also rose by 0.1% to 62.7%. Wage growth, however, beat prior estimates, as average hourly earnings climbed 0.4% from a month earlier, pushing the annual rate up to 2.9%, the highest level since 2009.

In the aftermath of the Federal Reserve's (Fed's) decision to raise interest rates at its December meeting, benchmark US Treasury yields rose to their highest level in two years, and the US dollar continued to gain ground against most other currencies. The healthy economic picture also prompted the Fed to increase its estimates for growth and the pace of potential future rate hikes, though these fresh predictions did not make any allowance for fiscal stimulus by the new administration, a possibility which has attracted much speculation since the election result. Nevertheless, the minutes of the Fed meeting indicated almost all of the board members had acknowledged the upside risks to their growth forecasts, due to the prospects for more expansionary fiscal policies in coming years. At the start of 2017, market estimates of the timing of future rate hikes remained more restrained than the Fed's predictions, pointing to only two rate hikes over 2017 rather than the three foreseen by the Fed.

Apart from December's stronger average hourly earnings data, signs of inflationary pressures remained scant. Headline and core personal consumption expenditures (PCE) price indexes for November both showed no change from a month earlier; on an annual basis, headline PCE was static at 1.4%, but core PCE fell from a revised 1.8% to 1.6%. Over the same period, the monthly change in personal income was also zero, held back by a slight dip in wages and salaries after outsized strength in recent months. Consumer spending in November came in at a lower-than-expected pace for the second consecutive month, providing further evidence that the fourth quarter of 2016 could well have seen more modest growth in expenditures by consumers than in previous quarters.

This year will likely offer up both opportunities and pitfalls for policymakers, but the solidity of current data reinforces our confidence the US economy is starting off on a sure footing. However, with meaningful change hard to engineer, both in terms of politics and economic outcomes, our sense is the pace of delivery may turn out to be slower than some market participants seem to expect, meaning the current moderate path for the economy could remain in place for some time yet.

**Confidence Picks Up Across Global Economy, Helped By Rising Commodities**

The fillip to confidence arising from the US election result was not confined to the United States. In Japan, a closely watched index showed optimism among larger companies rose in the final quarter of 2016 for the first time in 18 months. To a large degree, the change in sentiment reflected the better prospects for Japanese exports in the wake of a more-than-10% weakening of the Japanese yen against the US dollar since early November, with the yen's fall itself a product of the significant post-US election widening in yield differentials between Japanese and US government bonds.

China also benefited from hopes of a boost from stronger US expansion, in part due to a growing consensus among economists that global growth could pick up in 2017. Economic data from the world's second-largest economy generally remained positive, as a closely watched PMI for smaller, private Chinese manufacturing companies rose for the sixth consecutive month in December and the equivalent service sector PMI rose to a 17-month high. Profits at Chinese industrial companies showed robust growth in November, while the higher price of commodities also pushed China's annual producer price inflation for the same period up to 3.3%, its highest level in five years and a marked turnaround from the four consecutive years of falling input prices that had ended only three months previously.

Indeed, commodities staged a remarkable rebound from the multi-year lows reached early in 2016, so that a leading global index for the asset class registered its first annual positive return since 2010—despite the headwind in the latter part of the year of a strengthening US dollar, which by December had surged to a 14-year high against its main trading partners. Energy led the way, and the main oil benchmarks posted spot price gains of around 45%–55% in 2016, ending the year close to their highest levels since mid-2014. The turnaround in commodities was driven by a combination of a strengthening rebound in US economic activity, stimulus spending in China and monetary easing policies outside the United States, but improving fundamentals were also a crucial catalyst for the recovery in raw materials, as oversupply eased among energy and metals.

Emerging-market assets, which had seen some of the sharpest losses following the US election result, showed signs of stabilization near the turn of the year. Investors' reappraisal of the prospects for emerging markets underlined the mixture of potential positive and negative outcomes from the policy options available to the new US administration, with the benefits of any pickup in the US economy and global growth possibly offset by a more protectionist US stance. In addition, further increases in the US dollar and higher US interest rates could trigger outflows of capital and problems with US dollar-denominated debt for some emerging economies.

Globally, although overall activity levels and confidence have improved, the economic environment continues to be somewhat challenging, and we still feel the backdrop of slow-but-steady global growth is likely to remain fundamentally unaltered. To some degree, we think markets have already discounted positive expectations of the measures politicians are able to deliver, which could create further volatility if these hopes prove elevated compared to reality. Geopolitics could provide another source of market unease, as the potential for frictions arising from new political and trading alignments seems to us to have markedly increased.

**Inflation Rises Ahead of Crowded European Political Calendar**

Inflation appeared to show signs of life in the eurozone as 2016 ended, as data revealed annual headline inflation reached 1.1% in December, its highest level since 2013, with German headline inflation rising even higher to 1.7%. In addition, eurozone producer prices rose in November from a year earlier for the first time since 2013. The uptick in headline inflation, largely due to the recovery in energy prices, sparked some criticism of the ECB's decision toward the end of 2016 to extend its monetary easing program, and calls for a less dovish approach from the central bank. But core inflation figures were more supportive of the ECB's stance, remaining subdued at 0.9% in December from a year earlier, up only 0.1% from the previous month, and suggesting there was little sign of inflationary pressures building across the single-currency area.

In keeping with the trends across other parts of the globe, surveys in the eurozone indicated confidence had lifted, despite an uncertain political background. A survey of businesses and consumers conducted by the European Commission found economic sentiment among respondents in the monetary bloc at its most positive since 2011, while readings from countries outside the eurozone like Sweden, the United Kingdom and Poland also registered increases over the previous month. Even in Italy, which saw a change of prime minister following a December constitutional referendum and further uncertainty concerning the bailout of one of the country's largest banks, sentiment was merely unchanged.

Eurozone PMIs supported the brighter picture, with a leading composite index rising to its highest point since 2011. The data within the index for manufacturing were stronger than those covering services, probably reflecting the boost eurozone exporters have received from the weakness of the euro. The single currency was buffeted by the strength of the US dollar as well as the ECB's extension of monetary easing, briefly falling below US$1.04 against the US currency for the first time since 2003.

Data from the United Kingdom generally followed the same course as in the rest of Europe. UK consumer prices rose 1.2% over the year to November 2016, compared with 0.9% growth in October, marking the highest inflation rate since late 2014. A leading PMI covering the UK service sector climbed to a 17-month high in December, and its manufacturing equivalent reached the highest level in more than two years, boosted by the fall in the UK pound since the United Kingdom's vote to leave the European Union (Brexit). But with negotiations on the terms of the United Kingdom's departure widely expected to begin within a few months, at its December meeting the Bank of England warned uncertainty around the path for inflation and growth could see monetary policy either tightened or loosened during the coming year.

Although conditions in the European economy are nowhere near as solid as in the United States, they continue to slowly improve, as the ECB's monetary easing has further underpinned the region's halting recovery. The question remains whether this progress can be maintained in the face of any further political shocks. The forthcoming elections in the Netherlands, France, Germany and maybe Italy could limit the power of leading policymakers within the single-currency bloc, and further challenges may emerge over Europe's relations with the United States under the new US administration, as well as over the United Kingdom's Brexit negotiations. Although we are cognizant of the potential for such setbacks to hurt business and consumer confidence, our view is that these impacts would most likely be temporary, and the ECB's accommodative stance should continue to support a reasonable, if unspectacular, level of economic activity.

**What Are the Risks?**

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity.