FIXED INCOME

Global Economic Perspective: March

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In this month's Global Economic Perspective, Franklin Templeton Fixed Income Group weighs in on the factors spurring the US Fed's decision to raise rates, why the ECB's Draghi is likely to resist calls to adopt a more hawkish line, and why the backdrop for emerging markets has improved.

Perspective from Franklin Templeton Fixed Income Group®

In This Issue:

Investors Adjust to March Rate Hike, but US Growth Set to Remain Modest for Now

Even though confidence among US businesses and consumers has been lifted by the advent of a new administration, the question of whether this buoyant mood could translate into a significant pickup in US economic growth remains unanswered, in our view. The US Federal Reserve (Fed) looks likely to tighten monetary policy further, as inflation and unemployment move closer to its targets—underlining the strength of the domestic economy—but, while awaiting more substance on policy initiatives, we remain cautious about predictions of an end to the pattern of modest US growth seen in recent years.

China Announces Growth Target for 2017, and Oil Prices Dip as US Production Increases

China's economic growth target for 2017 was announced by the country's leadership as around 6.5%, a move widely seen as a further focus on stability and risk management, rather than on the creation of additional debt in order to sustain previous levels of growth. Elsewhere, signs of increasing US shale production weighed on oil prices. Overall, we would agree with the recent assessment by the Organisation for Economic Co-operation and Development (OECD) of only a relatively limited improvement to global economic growth over the rest of this year.

Political Uncertainty Likely to Overshadow Rising Inflation for ECB Policymakers

We think the speculation about a potential future tightening of monetary policy by the European Central Bank (ECB) has moved too far ahead of economic and political realities. The current pickup in inflation in the eurozone seems likely to be temporary, and while the region's growth rate has improved, there is little sign of the political appetite for the structural reforms needed. Indeed, given the uncertain political outlook, it could be argued any mandate for such measures looks more remote than ever. Against this background, we believe ECB President Mario Draghi will likely persuade his colleagues to continue with current accommodative policies.

Investors Adjust to March Fed Rate Hike, but US Growth Set to Remain Modest for Now

Even though confidence among US businesses and consumers has been lifted by the advent of a new administration, the question of whether this buoyant mood is likely to translate into a significant pickup in US economic growth remains unanswered, in our view. The Fed looks set to tighten monetary policy further, as inflation and unemployment move closer to its targets—underlining the strength of the domestic economy—and surging equity markets have added to already elevated consumer confidence. But the potential for delays and adjustments to anticipated growth-boosting policies poses risks, and we think the extent of these challenges may be underestimated.

Speculation about policy change has largely monopolized the attention of investors in the months since the US elections, but monetary policy came sharply back into focus during February. In her testimony to Congress, Fed Chair Janet Yellen—usually seen as one of the more dovish policymakers—delivered remarks that added weight to perceptions of a more hawkish stance from the Fed, although she was careful also to point out the considerable uncertainty around the outlook, particularly surrounding the new administration's economic plans. In reaction, market expectations that rates would rise three times in 2017—the Fed's indicated path for monetary policy—immediately increased, having fallen as low as 24% in early February, following the announcement of disappointing wage growth.

This re-appraisal of the likely path for US monetary policy gathered pace when some of the other more dovish members of the Fed's rate-setting panel appeared to change tack and indicate they believed rates should rise soon. Following further remarks from Fed Chair Yellen in early March, it was clear a rate hike at the next Fed meeting was all but certain, and the release of a strong labor market report for February removed any last potential doubts over such a move. After repeated episodes stretching back to 2013 when the Fed had failed to deliver predicted rate rises, market participants were now faced with a specific warning from Fed Chair Yellen that policy accommodation would be removed more quickly than in previous years. As a result, market expectations were rapidly revised, so that a total of three rate hikes over the year was now seen as the most likely scenario, and predictions of four increases even gained some traction. The Treasury market initially remained fairly resilient to this reversal of sentiment, but by early March benchmark yields had reached their highest level so far this year, ahead of the Fed's confirmation of its decision to raise interest rates.

One of the data releases that may well have pushed the Fed to act was the strength seen in its preferred inflation indicator, the personal consumption expenditures price index, in January. Rising energy costs pushed the headline month-on-month figure up to 0.4%, while the annual gain rose from 1.6% to 1.9%, only a tenth below the Fed's target for inflation. However, mounting inflationary pressures were less apparent at the core level, where the equivalent monthly and annual numbers were 0.3% and 1.7%, the latter unchanged from the previous reading.

Business and consumer surveys broadly continued to suggest the post-election bounce in sentiment was intact, despite signs some policy initiatives from the Trump administration—including key tax and health care reforms—might take longer to implement, and in some cases be less radical, than earlier indications. Nevertheless, the new President's stance on reducing regulation remained an attractive message for companies and investors, and in his first address to Congress at the end of February, he underlined his intention to increase defense and infrastructure spending. In the wake of the President's address, broad US equity indexes posted new highs.

As mentioned, February's labor market report was strong, with nonfarm payrolls up by 235,000—well ahead of consensus expectations of 200,000—and an upward revision to January's already robust job gains number. However, February's outsized rise may have been enhanced by unseasonably warm weather, with the number of additional construction jobs rising by the largest amount in several years. The unemployment rate dipped a tenth to 4.7%, despite a similar-sized increase in the labor force participation rate, which moved up to 63.0%. Average hourly earnings remained somewhat sluggish, up 0.2% from the previous month, although that rise was enough to push the annual figure back up, from 2.5% to 2.8%.

Notwithstanding the positive signals from the labor market and the pickup in sentiment, consensus estimates for US first-quarter 2017 growth showed little change, staying in the 1.5%–2.0% band that has prevailed in recent years. Early indications for consumer spending—which was revised sharply higher for the fourth quarter of 2016—pointed to a slight slowdown, with only a 0.2% monthly gain in January, compared with 0.5% in the previous month. But after figures showed trade had subtracted 1.7% from fourth-quarter gross domestic product (GDP) growth, this factor again seemed likely to prove a significant headwind, as January's trade deficit grew to its widest level since 2012.

We feel the restrained first-quarter GDP consensus forecasts reflect the contrast between a domestic economy doing relatively well, and which has spurred the Fed into action, and a less robust backdrop internationally. The Fed's move underlines that policymakers believe the current US expansion is resilient enough to withstand a less accommodative monetary stance. Nonetheless, we would not read too much more into the Fed tightening, and, while awaiting more substance on policy initiatives, we remain cautious about predictions that the US economy will soon break out of the pattern of modest growth seen in recent years.

China Announces Growth Target for 2017, and Oil Prices Dip as US Production Increases

China's leadership announced the country's economic growth target for 2017 as around 6.5%, a slight dip from last year's 6.5%–7.0% range. The move was widely seen as a further sign of the shifting priorities of the Chinese government, with more of a focus on stability and risk management, rather than on the creation of additional debt in order to sustain previous levels of growth. In February, China's official purchasing managers' index (PMI) for the manufacturing sector remained well above the 50 level indicating expansion and showed a slight increase for January. Trade data for the same month revealed the country incurred its first trade deficit in local-currency terms since early 2014, mainly due to a surge in imports, although the figures were probably affected by the timing of the Lunar New Year holiday. In contrast, China's foreign-exchange reserves rose in February for the first time in eight months, providing some evidence—along with the relative stability of the Chinese renminbi so far this year—that the Chinese authorities' efforts to limit capital outflows have been having some effect.

The Mexican peso continued to rebound from its all-time low against the US dollar of around 22 pesos, reached soon after the start of this year. In February, Mexico's central bank launched a US$20 billion currency hedging program—broadly similar to a policy used in 2015 by Brazilian policymakers to stem a fall in the Brazilian real—which had the advantage of providing support for the peso without draining the country's foreign-exchange reserves. The peso was subsequently boosted by comments from US Commerce Secretary Wilbur Ross, who struck a more conciliatory tone when describing relations between the United States and Mexico, even offering US assistance to help stabilize the Mexican currency. By early March, the peso had risen to its highest level against the dollar since the US elections.

Elsewhere, signs of increasing US shale production weighed on oil prices. Following an agreement late last year among members of the Organization of the Petroleum Exporting Countries and several other large oil-producing countries to restrict supplies, prices rose and largely held their gains as participants appeared to be mostly complying with the terms of the deal. But in early March figures revealed that a resurgence in production in US shale fields had increased US crude inventories to record levels, which pushed a leading benchmark for oil prices below US$50 per barrel for the first time this year.

South Korean markets were generally stable after the country's president, Park Geun-hye, was removed from office by a court ruling, which upheld her impeachment by the South Korean parliament at the end of 2016. As the trial of the head of one of South Korea's largest conglomerates on corruption charges got underway, the president's ousting meant she lost her immunity to prosecution over the corruption scandal that forced her from office. South Korea has faced slowing growth and rising unemployment, while tensions with China, the country's largest trading partner, have risen after South Korea unveiled plans to deploy a US missile shield, although the front-runner to become the country's next president has said he will re-examine that decision if elected.

The re-assuring signs about China's economic growth, along with the absence of protectionist measures so far from the Trump administration, have helped create a better backdrop for many emerging markets in recent months. We think several countries in this category appear to have sound fundamentals and should be well placed to weather any volatility if either of these factors cease to be supportive. Overall, however, we would agree with the recent assessment by the OECD of only a relatively limited improvement to global economic growth over the rest of this year.

Political Uncertainty Likely to Overshadow Rising Inflation for ECB Policymakers

Data from the eurozone continued to indicate levels of growth close to the single-currency region's maximum potential rate, which remains constrained by the absence of any significant moves to adopt the type of structural reforms urged by many economists and market participants. The eurozone's manufacturing PMI for February rose to its best level since 2011, and a leading measure of German business confidence for the same month climbed back up to the four-year high seen at the end of 2016. Even French consumers seemed untroubled by ongoing political uncertainty ahead of the first round of the country's presidential election, scheduled for late April, as the February reading of a key measure of sentiment among the country's consumers remained at its highest level for a decade.

Inflation in the eurozone also continued its upward trajectory in February, hitting an estimated annual rate of 2.0%, its highest level in four years. But while the headline numbers were strong, after stripping out the fading impact of past declines in energy costs, core inflation over the same period remained subdued at just 0.9%. Earlier figures covering January marked an important milestone in the region's battle against deflation, showing all of the monetary bloc's individual member states had recorded price rises for the first time since February 2013.

The ECB's meeting in March produced few surprises, though the central bank did increase its inflation forecast for the current year from 1.3% to 1.7%. However, the ECB left its estimate for 2019 unchanged—with inflation still expected to be short of its target of close-to-but-below 2%—underlining how policymakers view the upswing in pricing pressures as transitory. Market participants closely studied ECB President Mario Draghi's accompanying remarks for any clues about the path ahead for monetary policy, but he batted away suggestions of any changes to the ECB's bond-purchasing program. Nevertheless, the apparent success of the ECB's policy in overcoming the threat of deflation increased speculation about a potential tightening of monetary policy, possibly even before the cessation of the central bank's bond purchases—scheduled to continue for at least the rest of the year—and in the wake of the ECB meeting pushed market estimates of the odds of a rise in official interest rates before the end of 2017 to more than 50%. The speculation also prompted rises in German Bund yields and the euro.

In the first such event of a year crowded with European elections, the Netherlands prepared to go to the polls in mid-March, potentially providing an early reading of political sentiment among European voters following several populist upsets in 2016. However, the scope for another shock seemed limited by the fragmented nature of Dutch politics, which has traditionally produced a multi-party governing coalition, and meant even substantial gains for the leading populist party would be unlikely to allow it to gain access to power.

We think the speculation about a potential future tightening of monetary policy by the ECB—whether in the form of a tapering of bond purchases or a rise in interest rates—has moved too far ahead of the economic and political realities within the eurozone. Absent future significant inflationary pressures elsewhere in the global economy, the current pickup in inflation in the region seems likely to be a temporary phenomenon, and while the growth rate across much of the eurozone has improved, we believe it remains short of the levels necessary to be self-sustaining, with little sign of the political appetite for the structural reforms needed for such changes to take place. Indeed, given the uncertain political outlook, it could be argued any mandate at the national or regional level for such measures looks more remote than ever. Against this background, we believe ECB President Mario Draghi will likely persuade his colleagues to continue with current accommodative policies and resist calls to adopt a more hawkish line.

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