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Franklin Templeton Fixed Income Group® talks monetary policy, European politics in the April Global Economic Perspective.

Perspective from Franklin Templeton Fixed Income Group®

In This Issue:

Broader Growth Across US Economy Provides Solid Backdrop for Further Interest-Rate Hikes

Recent signs of a better balance to the growth seen across the US economy strengthen the foundations of the current expansion, in our view. They also enhance the case for a return to a more neutral monetary policy. With the economy performing solidly, we expect the US Federal Reserve (Fed) to continue moving incrementally toward normalizing interest rates. But the Fed's March statement suggested to us it was unlikely to be hurried into any further action by a single piece of data and instead would make a wider judgement on the appropriate setting for monetary policy, based on a range of readings across the economy and financial markets.

Softer US Dollar Boosts Many Emerging Markets, but Global Growth Still Looks Slow and Steady

Many emerging markets enjoyed favorable conditions, helped by the softer US dollar, solid demand from China and an absence (to date) of protectionist trade measures from the Trump administration. In the medium term, however, we still see underlying global economic conditions as indicative of slow but steady growth. Sentiment indicators may have picked up across much of the world, but large parts of the global economy continue to rely on substantial monetary stimulus, and political risk remains a significant concern for investors, in both Europe and the United States.

Inflation Slowdown Strengthens ECB Case for Resisting Calls To Change Monetary Policy

We think European Central Bank (ECB) President Mario Draghi's firm line on resisting pressure to adjust the central bank's accommodative monetary policy is the correct one. With an energy-related rebound in inflation fading, signs of improving economic conditions need to be put into perspective, as the output gap across the region as a whole remains large, and so does the slack in its labor market. For a stronger recovery to take hold across the whole of Europe, greater political stability, allowing the promotion of significant growth-enhancing structural reforms, is probably required. However, avoiding a premature tightening of monetary policy would also seem to be a prerequisite.

Broader Growth Across US Economy Provides Solid Backdrop for Further Interest-Rate Hikes

Recent signs of a better balance to the growth seen across the US economy strengthen the foundations of the current expansion, in our view. They also enhance the case for a return to a more neutral monetary policy. With the economy performing solidly, we expect the Fed to continue moving incrementally toward normalizing interest rates. But, judging from recent messaging, Fed policymakers have yet to see compelling evidence of an acceleration in overall activity, viewing growth as set to remain at around trend rates, and are reluctant to factor in any significant impact from the Trump administration's future policies. The Fed's statement following its March meeting suggested to us it was unlikely to be hurried into any further interest-rate hikes by a single piece of inflation or employment data crossing a particular threshold and instead would make a wider judgement on the appropriate setting for monetary policy, based on a range of readings across the economy and financial markets.

After market participants appeared largely prepared for a hawkish update from the Fed in March, to accompany a well-flagged 25 basis-point rise in the fed funds target rate, some were surprised by the restrained tone of its statement. Rather than stressing vigilance about future inflationary risks, Fed policymakers re-iterated their view that core inflation was likely to rise only gradually, eventually stabilizing around their 2% target level. The Fed's longer-term growth estimate for the US economy was left unchanged at 1.8%, underlining caution among policymakers in light of political uncertainty about potential policy shifts under the Trump administration. Benchmark Treasury yields, which had risen ahead of the Fed meeting, quickly turned lower. They later fell to the lower end of their trading band so far this year, after the retraction of President Trump's health care reform legislation magnified concerns that planned tax reforms might face similar problems.

Despite the Fed's caution, there were signs growth in the economy might be broadening, with an increased contribution from segments that were previously more subdued. Data from the corporate sector generally remained firm, suggesting the prior optimism might be translating into a sustained improvement. In both January and February, manufacturing output registered a 0.5% monthly rise, the largest since mid-2015 and marking a run of six consecutive monthly increases, amid further expansion in capacity utilization among manufacturers. Spending on construction also sharply rebounded in February from an upwardly revised drop in the previous month.

Sentiment among corporations remained upbeat as well, with impressive levels of new orders continuing in March's Institute for Supply Management purchasing managers' index (PMI) for manufacturing. The PMI component for export orders was another notable area of strength, indicating overseas demand had not been impacted so far by the sharp rise in the US dollar in late 2016. Elsewhere, a leading quarterly survey of US chief financial officers showed confidence at its highest level for more than a decade. Another index—based on a poll of chief executive officers' projections for sales, capital spending and hiring over the next six months—increased by the most since 2009.

In contrast, while surveys of consumer confidence generally remained close to recent highs, these sentiment indicators were somewhat at odds with underlying levels of economic activity. February saw another relatively weak reading for consumer spending, in the wake of January's soft data, and was followed in March by a drop in auto sales, marking a third consecutive monthly fall. Spending on autos was a key element of growth for the economy in 2016, with sales reaching record levels, but the latest figures again fell short of market expectations, despite rising inventories leading to heavy discounting by manufacturers. Overall, these indicators pointed to the likelihood of a modest slowdown in the contribution to growth from consumers over the first quarter—arguably, a welcome development, given consumers' outsized impact in the final quarter of 2016. Partly as a result, first-quarter gross domestic product forecasts mostly remained subdued. Moreover, for reasons that have yet to be fully understood, historically the first quarter has often seen uncharacteristically slow US growth, prior to a pick-up in activity later in the year.

The labor market was another area of the economy where there were signs of consolidation at the end of the first quarter, after it had previously outperformed expectations for several months. March's nonfarm payrolls came in well short of consensus estimates, with an increase of only 98,000 jobs, together with small downward revisions to previous readings. Weather may have played a part in the weaker numbers. Additionally, there was another large decrease in retail positions, underlining the pressure on brick-and-mortar stores, as customers continued to move online. Construction, a significant positive in the February report, saw its contribution dwindle. The rest of the March report showed the unemployment rate unexpectedly falling by 0.2% to 4.5%, the lowest rate since 2007, while wage growth also dipped, by 0.1% to 2.7%, compared with a year earlier.

Though wage increases remained in check, other inflation data mostly continued to gradually tick higher. The Fed's favored measure, the personal consumption expenditures price index, moved up 0.2% to 2.1% year-on-year in February at the headline level, though the core measure was unchanged at 1.8%, after the previous month's reading was revised up by a tenth. The headline Consumer Price Index for February also inched ahead, up to 2.7% compared with a year earlier—its highest level since 2012—driven largely by the rebound in energy prices, while the equivalent core rate remained steady at 2.2%.

Overall, we regard the data as supporting a positive view of the US economy, with a greater balance among the drivers of economic growth another indication of the depth and breadth of the recovery. Though there have been a few signs of a slowdown in consumer spending and hiring, at this stage these look like reversions to more sustainable levels of activity, in our view, rather than anything more significant.

Softer US Dollar Boosts Many Emerging Markets, but Global Growth Still Looks Slow and Steady

One of the side-effects of the Fed's statement was a pullback in the US dollar, which by late March had fallen to its lowest point on a trade-weighted basis since November 2016. Currencies profiting from the dollar's weakness included many from emerging markets, which collectively registered one of their strongest quarters in many years. In fact, a broad range of emerging-market assets enjoyed a favorable backdrop, boosted by a number of additional factors, including solid demand from China—which bolstered revenues for many commodity producers—and an absence (to date) of protectionist trade measures from the Trump administration. Encouraged by these tailwinds, investors responded by increasing their exposure, pushing investment flows to emerging markets in March to their highest monthly level since the start of 2015.

However, the contrasting fortunes of some emerging markets were conveyed by changes to their respective credit ratings. Argentina's long-term credit rating was upgraded by Standard & Poor's—though it remained well below investment-grade—as the ratings agency became the latest to raise its assessment of the country's prospects, acknowledging the reforms undertaken since a new government, led by President Mauricio Macri, came to power in late 2015. South Africa's rating moved in the opposite direction—losing its investment-grade status—after the removal of the country's respected finance minister by President Jacob Zuma. The South African rand sold off sharply on the news of the government reshuffle.

As mentioned, updates from the Chinese economy remained broadly positive, adding to evidence of its reasonably strong start to the year. Official PMI figures for manufacturing covering March came in ahead of consensus expectations, with the employment sub-index suggesting China's factories were a net contributor to employment for the first time in five years. Additionally, profits among Chinese industrial companies jumped in the first two months of 2017. However, independent surveys of activity were a little more subdued, with one gauge covering services falling to a six-month low. Nevertheless, data indicated net capital flows into China turned positive in February, reversing a run of outflows going back nearly three years.

Another of the main beneficiaries of the US dollar's weakness was the Japanese yen. It has continued an advance against the US currency—begun at the end of 2016—that has reversed much of the yen's sharp decline immediately after the US presidential election. The rebound in the yen, which has caused a de facto tightening in Japanese monetary conditions, creates a further headache for the Bank of Japan, as it continues its extensive quantitative easing program, against an economic background in which inflation indicators have remained sluggish.

Among commodities, oil prices moved higher as fears about rising US shale production abated somewhat, and market participants began giving more weight to the effectiveness of supply cuts by members of the Organization of the Petroleum Exporting Countries and several other large oil-producing countries. In early April, military action by the United States against Syria increased geopolitical concerns, pushing prices up further.

In the medium term, we still see underlying global economic conditions as indicative of slow but steady growth. Sentiment indicators may have picked up across much of the world, but large parts of the global economy continue to rely on substantial monetary stimulus, and political risk remains a significant concern for investors, in both Europe and the United States. We anticipate such a backdrop could lead to increased market volatility, in contrast to the relative calm seen so far this year.

Inflation Slowdown Strengthens ECB Case for Resisting Calls To Change Monetary Policy

Economic news from the eurozone remained broadly positive. Forward-looking indicators like PMIs—which hit a six-year high for the region as a whole in March—held out the promise of relatively strong growth over the first quarter. Unemployment data underlined the extent of the recovery in labor markets, with the ratio of jobless workers falling to its lowest level since 2009, although around a tenth of the workforce still remained out of work. After rising for several months, annual inflation in the eurozone fell further than consensus expectations in March, easing back from 2.0% to 1.5% at the headline level, and from 0.9% to 0.7% at the core level. Previous price rises appeared to have weighed on consumer spending in February, as both German and Spanish retail sales came in lower than generally predicted.

The fall in inflation from its previous four-year high helped the ECB to fend off some of its more hawkish critics, who had argued the central bank was failing to take into account rising pricing pressures and needed to adjust its monetary policy to a less accommodative setting. ECB President Mario Draghi had consistently rejected such calls, previously talking of the need to see core inflation re-emerge and rise steadily over a number of months, before considering an end to the central bank's quantitative easing program, currently projected to last until at least the end of 2017.

As it had announced at the end of 2016, the ECB cut the size of its monthly bond purchases from €80 billion to €60 billion in April, but President Draghi also moved to quell speculation about an increase in the ECB's deposit rate later this year, which some critics had called for, even before any curtailment of the ECB's quantitative easing program. Following his comments, with the prospect of a rise in eurozone interest rates apparently pushed back to 2018 at the earliest, the euro—which had already dipped in the wake of the lower-than-expected inflation figures—gave up more ground.

There was a brief lull in Europe’s crowded election calendar, but polls in the run-up to the first round of voting in France’s presidential contest in late April suggested the centrist-candidate Emmanuel Macron was gaining support, which continued to soothe market concerns about a possible victory for the populist Marine Le Pen. In Germany, Chancellor Angela Merkel’s center-right Christian Democrat Union party comfortably won a small regional election, doing better than expected against its main rival, the Social Democrats, and providing a welcome boost for the German leader, ahead of national elections due in September.

At the end of March, the UK government fulfilled its promise to begin the process of leaving the European Union (EU), officially notifying its European partners of its intentions. UK Prime Minister Theresa May then unexpectedly announced elections to be held in June, meaning the scheduled two years of negotiations to determine the terms of the United Kingdom’s departure seemed unlikely to make much headway until after the results of the UK vote —and probably the German elections as well—were known. At its March meeting, the Bank of England left UK interest rates unchanged, but did refer to the possibility of rising inflationary pressures prompting a tightening of monetary policy, with one policymaker dissenting and voting for immediate action. However, after retail sales for the three months to February-end fell by the most since 2010, the signs higher prices could be impacting spending by UK consumers increased uncertainty about the strength of the UK economy.

Polls in the United Kingdom indicate the forthcoming election is likely to increase the majority of the ruling Conservative Party, an outcome that should strengthen Prime Minister May’s position at home and on the international stage at a crucial time, and one we think would be welcomed by financial markets. However, in our view, the Brexit negotiations could potentially be as transformative for the EU as for the United Kingdom over the longer term. It is possible the process will highlight pre-existing tensions among the remaining EU members—between those states that believe in moving toward a more deeply integrated, federalist structure, and those largely opposed to further transfers of power from national to regional bodies, preferring to maintain the status quo—and in doing so hasten the move to a so-called “two-speed” EU.

As has been the case for a number of years in Europe, the political backdrop remains uncertain, and this is one of the reasons we think President Draghi’s firm line on resisting calls to adjust the ECB’s accommodative monetary policy is the correct one. With an energy-related rebound in inflation fading, signs of improving economic conditions need to be put into perspective—despite the strong performance of Germany, the bloc’s largest economy—as the output gap across the region as a whole remains large, and so does the slack in its labor market. For a stronger recovery to take hold across the whole of Europe, greater political stability, allowing the promotion of significant growth-enhancing structural reforms, is probably required. However, ahead of any such developments, avoiding a premature tightening of monetary policy would also seem to be a prerequisite.

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