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Global Economic Perspective: May

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In this month's Global Economic Perspective, Franklin Templeton Fixed Income Group examines the aftermath of the French election in Europe, signs of a pickup in global growth, and whether Japan's "Abenomics" experiment is working.

Perspective from Franklin Templeton Fixed Income Group®

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US Economy Set to Rebound from Weak Start to 2017 as Fundamentals Remain Solid

We concur with recent comments by US Federal Reserve (Fed) policymakers that US economic weakness seen in first-quarter data is likely to be transitory, and that activity should pick up over the rest of the year. With the favorable backdrop for US consumers supported by the robust labor market and the ongoing strength of housing and stocks, we think fundamentals remain in good shape. That said, there is currently little sign of any acceleration in activity or inflation, and any potential stimulus from the Trump administration still seems some way off, so the trend growth rate of around 2% looks set to continue in the near term. Nevertheless, we believe the economic backdrop remains sufficiently healthy for the Fed to continue moving incrementally toward its goal of normalizing monetary policy.

Global Economy Showing Gradual Improvement but Commodity Markets Volatile

Our sense is that the global economy has maintained the gently positive momentum that has been the pattern for some time now, despite the swings in short-term sentiment principally caused by political events. Notwithstanding recent volatility in commodity markets, sentiment surveys remain strongly positive in many parts of the world, but definite signs of an acceleration in activity have been scarcer, probably due to the structural impediments that have characterized the years since the global financial crisis.

Positive Eurozone Data and French Election Result Boost Sentiment

Although eurozone data have improved, we feel speculation about an impending policy shift by the European Central Bank (ECB) is overdone. After attracting criticism in the past over what were widely seen as premature policy moves, it seems more likely the ECB will be inclined to err on the side of caution this time around. Although the path for negotiations on the United Kingdom's departure from the European Union (EU) remains uncertain, the French presidential election result has removed another potential political risk that may have been holding back activity in some parts of Europe. Nevertheless, we think the ECB is likely to wait for far more compelling evidence that the eurozone economy is generating appropriate and sustainable levels of price increases before contemplating a change of stance.

US Economy Set to Rebound from Weak Start to 2017 as Fundamentals Remain Solid

We concur with recent comments by Fed policymakers that US economic weakness seen in first-quarter data is likely to be transitory, and that activity should pick up over the rest of the year. For some time now, disappointing US growth in the first quarter has, more often than not, been an outlier—the reasons for which have yet to be fully explained. But with the favorable backdrop for US consumers supported by the robust labor market and the ongoing strength of housing and stocks, we think fundamentals remain in good shape. That said, there is currently little sign of any acceleration in activity or inflation, and any potential stimulus from the Trump administration still seems some way off, so the trend growth rate of around 2% looks set to continue in the near term. Nevertheless, we believe the economic backdrop remains sufficiently healthy for the Fed to continue moving incrementally toward its goal of normalizing monetary policy.

A key part of the positive underlying picture for US consumers was reinforced by April's labor report, as payroll gains came in ahead of consensus expectations at 211,000. The data showed a rebound from March's softer-than-expected jobs number, and minor revisions left the first-quarter average at 176,000, only a small dip from the average seen over 2016. The unemployment rate continued to fall in April, reaching another post-financial crisis low of 4.4%, although this was partly offset by a marginal decline in the labor force participation rate. In addition, one of the broadest measures of underemployment registered a notable decline, from the previous month's 8.9% to 8.6% in April. Despite the tight labor market, wage growth remained subdued, with the annual rate falling from 2.6% to 2.5%, its lowest level since August 2016.

Though the labor market appeared to remain on track, prior indications of a sluggish start to the year by the US economy were confirmed by initial estimates for first-quarter economic growth. The 0.7% annualized expansion in gross domestic product (GDP) was the weakest seen since 2014; the slowdown from the previous quarter's rate of 2.1% was largely due to consumers spending less and slimmer corporate inventories. Seeking to further explain the weakness, a number of economists emphasized the recurring pattern evident in quarterly GDP numbers since 2010—whereby first-quarter growth has averaged less than half the rate for the rest of the year—raising suspicions that seasonal effects may be skewing the data. As a result, the impact of the weak GDP number on sentiment and financial markets was muted.

Retail sales for March were also soft, declining by 0.2% from the previous month, and were accompanied by a sizable downward revision of February's figures to an even sharper drop. Much of the weakness centered on auto sales, which fell by 1.2% in March, marking the third consecutive monthly weakening, and a significant turnaround for a part of the economy that was a solid driver of consumer spending during 2016. The GDP and retail sales data, pointing to more cautious expenditure by US households, contrasted with readings for consumer confidence, which generally showed little sign of dipping from the elevated levels seen since the US election.

However, in the corporate sector, there were signs the unusually upbeat tone of surveys seen in prior months and the less buoyant hard data might be starting to converge, as sentiment fell back to more realistic levels. April's Institute for Supply Management purchasing managers' index (PMI) for manufacturing came in below consensus expectations, although still registering a solid 54.8 (a reading above 50 indicates expansion). The report showed particular strength in export orders, indicating US firms in general were gaining from a pickup in the global economy despite the rise in the US dollar. But data such as the March reports for industrial production and durable goods were more downbeat, showing little sign of the strength previous surveys had intimated.

Updates on inflation tallied with the backdrop suggested by the first-quarter GDP numbers. The core personal consumption expenditures price index—the measure of inflation most closely watched by the Fed—fell by 0.1% month-on-month in March, its weakest showing in 16 years, taking the annual rate down to 1.6%. The equivalent headline number posted an even larger monthly decline to 1.8%, down from 2.1% in the previous month. Consumer price indexes told a similar story, with annual core and headline rates for March declining to 2.0% and 2.4%, respectively.

It seems likely the current quarter's data will allow a more accurate appraisal of the state of the US economy, following its now almost traditional first-quarter blip. However, with the labor market getting ever tighter, most market participants are already looking to the Fed to raise interest rates at its next meeting in June. As Fed policymakers weigh future moves, they may also be eyeing the more positive signals coming from many other parts of the global economy. Unless there are indications of any significant upward pressure on US wages or broader inflation measures, we think it is hard to see any shift in policy by the Fed to accelerate the pace of tightening.

Global Economy Showing Gradual Improvement but Commodity Markets Volatile

The theme of a broad-based pickup in global growth was echoed by the International Monetary Fund (IMF) in its latest quarterly economic update. The institution marginally increased its forecast for global expansion for the current year to 3.5%, up from an estimated 3.1% in 2016. The IMF pointed to an improved outlook for Europe and Japan, based on a cyclical recovery in global manufacturing and trade that started in the second half of 2016, and it modestly raised its 2017 growth forecasts for both to 1.7% and 1.2%, respectively.

Though the IMF upgrade struck a positive note on the Japanese economy, there remained much debate about the effectiveness of efforts dating back to 2012 by Shinzo Abe, the country's prime minister, to address deflationary pressures within the economy. Involving a mixture of fiscal, monetary and economic measures, the policies—collectively known as Abenomics—have had few obvious successes, and inflation has barely remained positive over much of the period. Despite suppressing interest rates for many years to bolster its credibility on inflation, the Bank of Japan has been forced to pledge significant ongoing monetary stimulus until price rises stabilize above its 2% target. On the plus side, a weaker yen has boosted exporters and Japan's labor market has tightened significantly. However, domestic demand and wages have stubbornly refused to pick up. Translating helpful developments into more substantive progress on inflation still seems a difficult task in the near term, and in terms of investment potential, we remain skeptical about Japan's fundamentals, given its elevated overall debt levels.

Additional support for the picture of firmer global growth was provided by China's first-quarter GDP numbers. The data showed the quickest expansion since mid-2015, boosted by strong activity among manufacturers and real-estate developers, as well as increased credit growth. But no sooner had China's industrial base started to show some positive effects from the pickup in global commodity prices—which has allowed its factories to push through some price increases after many years of producer price deflation—than several of the industrial materials most reliant on Chinese demand started to come under pressure during April. To some extent, the falling prices of commodities such as iron ore and copper appeared related to attempts by Chinese authorities to rein in credit expansion, principally through stricter regulation of the financial sector and a tightening of liquidity in money markets used by banks and companies for funding. It remained unclear whether these policies—which if pursued over a more extended period could potentially undermine the country's growth targets—would continue, particularly given Chinese policymakers' desire for stability ahead of November's important People's Congress.

Another commodity to register a sharp pullback over April and early May was oil. Market participants continued to weigh the supply-side impact of production cuts by the Organization of the Petroleum Exporting Countries (OPEC) and other major oil producers in late 2016 and, on the other hand, the ability of the US shale oil industry to maintain output in the face of lower prices. Growing doubts about the effectiveness of the OPEC-led cuts and a series of increases in US oil inventories culminated in a 10% drop in crude prices in a single week, though prices later steadied.

Our sense is that the global economy has maintained the gently positive momentum that has been the pattern for some time now, despite the swings in short-term sentiment principally caused by political events. While sentiment surveys remain strongly positive in many parts of the world, definite signs of an acceleration in activity have been scarcer, probably due to the structural impediments that have characterized the years since the global financial crisis.

Positive Eurozone Data and French Election Result Boost Sentiment

Economic indicators for the eurozone remained generally positive, with some suggesting the region's recovery is broadening. The final reading for a leading PMI covering both manufacturing and services across the single-currency bloc climbed in April to its highest level in six years, and it appeared to signal synchronized improvement extending across all of the larger economies. A widely followed index of German business sentiment also hit a six-year high. Additionally, a separate monthly report from the Bundesbank described the mood among German manufacturers as extraordinarily optimistic.

Data covering the first three months of 2017 indicated eurozone GDP grew at a respectable 0.5% from the previous quarter. National data pointed to continued strength in the Spanish economy but a loss of momentum in France, as French consumers reined in their spending, probably due to political uncertainty in the run-up to the country's presidential election. After a surprisingly large dip in the previous month, eurozone inflation rebounded in April, with the annual increase in core prices accelerating to its highest level since 2013. The comparable figure for headline inflation moved up from 1.5% to 1.9%, bringing it back up to the ECB's target of slightly below 2%.

At the ECB's meeting near the end of April, ECB President Mario Draghi described the region's current recovery as solid and broad, and underlined the contrast with what he termed as last year's fragile and uneven expansion. ECB policymakers also adjusted their assessment of the risks to growth, saying for the first time that the risks were "moving toward a more balanced configuration," although cautioning that risks were still tilted to the downside, mainly due to global factors. At the same time, Draghi re-iterated his belief that inflationary pressures in the region remained too weak to begin signaling any reduction in the central bank's monetary stimulus. However, his comments failed to dampen speculation among market participants that the ECB's meeting in June could see some hints of movement in this area.

Concerns that the French presidential election would see a surge of support for populism among French voters were allayed by the results from the first round of voting toward the end of April. Even though the outcome of the first vote eliminated candidates from the traditional parties, the results pointed to an eventual victory for independent centrist candidate Emmanuel Macron. Such predictions were confirmed by his sweeping victory over right-winger Marine Le Pen in the second ballot. Seen as a strong supporter of a deepening of ties between the member states of the EU, Macron's win pushed the euro up briefly to a six-month high against the US dollar. However, the president-elect is faced with the difficult challenge of expanding his party's representation to build support for his policies in time for French parliamentary elections due to take place in June. Having founded his party, En Marche, only around a year before the presidential election, it currently has no members in the National Assembly.

In an unexpected move, UK Prime Minister Theresa May announced a general election to be held in June, with polls indicating a likely increase in the parliamentary majority of the ruling Conservative Party. The prime minister's decision to call an election was widely seen as an attempt to strengthen her authority during forthcoming negotiations on the terms of the United Kingdom's departure from the EU. However, a meeting between the UK government and EU officials appeared to underline the conflicting agendas of both parties, leading to signs of increased tension as each side attempted to gain ascendancy for their respective positions through the media.

Although improved data have fueled optimism about the recovery in the eurozone, we feel speculation about an impending policy shift by the ECB is overdone. After attracting criticism over what were widely seen as premature moves to tighten monetary policy before the start of the eurozone crisis in 2011–2012, it seems more likely the ECB will be inclined to err on the side of caution this time around. Although the path for negotiations on the United Kingdom's departure from the EU remains uncertain, the French election result has removed another potential political risk that may have been holding back activity in some parts of Europe. Nevertheless, with the ECB's own inflation forecast for 2019 still only at 1.7%, our sense is that ECB President Draghi is likely to wait for far more compelling evidence that the eurozone economy is generating appropriate and sustainable levels of price increases before contemplating a change of stance.

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