FIXED INCOME

Global Economic Perspective: August

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Christopher J. Molumphy, CFA
Executive Vice President,
Chief Investment Officer,
Franklin Templeton Fixed Income Group®

David Zahn, CFA, FRM
Head of European Fixed Income,
Senior Vice President,
Franklin Templeton Fixed Income Group®

John Beck
Director of Fixed Income, London
Senior Vice President,
Franklin Templeton Fixed Income Group®

Michael Materasso
Senior Vice President,
Head of Insurance Asset Management,
Franklin Templeton Fixed Income Group®

Roger Bayston, CFA
Senior Vice President,
Portfolio Manager,
Franklin Templeton Fixed Income Group®

In this month's Global Economic Perspective, Franklin Templeton Fixed Income Group takes a look at recent US economic data, and increased skepticism among many market participants about whether the Federal Reserve will implement another increase in interest rates before the end of the year.

Perspective from Franklin Templeton Fixed Income Group®

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Healthy Backdrop for Consumers and Corporates Underpins Solid but Modest Growth
The backdrop for the US economy looks healthy, in our view, as consumers continue to spend robustly and companies increase investment. The strength of the labor market, allied with rises in the stock market and in housing, provide further potential support for consumer spending. However, in the absence of catalysts for an acceleration of growth, we think the rate of expansion is likely to remain around current modest levels. The lack of pricing power affecting both companies and labor is evident in weak inflation and wage growth data, a trend also evident in many other countries, suggesting it may endure for some time.

Asian Economies' Performance Indicative of Improved Global Economic Growth
The relatively strong performance of Japan and China, Asia's two largest economies, underlines the more positive picture in large parts of the global economy so far in 2017, even if the overall level of growth is steady rather than elevated. Against this background, we think that the divergences in the monetary policies of the major economies are likely to become more apparent, which could increase pressure on some central banks and magnify market volatility.

Eurozone Data Strong but ECB Keeps Monetary Policy Unchanged

We believe an adjustment in the European Central Bank's (ECB's) monetary-policy settings looks likely to be made soon, as it would be surprising if the central bank continued on its current highly accommodative course for much longer, considering the stronger-than-expected recovery in the eurozone economy. But our view is that the start of any tapering of the ECB's bond purchases is likely to be delayed until 2018, and would perhaps be more gradually implemented than is widely expected, until policymakers can be more confident that inflation will return and remain close to their target of around 2%.

Healthy Backdrop for Consumers and Corporates Underpins Solid but Modest Growth

The backdrop for the US economy looks healthy, in our view, as consumers continue to spend robustly and companies increase investment. The strength of the labor market, allied to rises in the stock market and in housing, provide further potential support for consumer spending. However, in the absence of catalysts for an acceleration of growth—for example, the introduction of a comprehensive package of tax reforms—we think the rate of expansion is likely to remain around current modest levels. The lack of pricing power affecting both companies and labor is evident in weak inflation and wage growth data, a trend also evident in many other countries, suggesting it may endure for some time. As a result, we believe the Fed's ultimate target for interest rates when normalizing monetary policy could remain relatively low, unless pricing pressures that are more typical of previous late-cycle economic expansions start to emerge.

Figures for the second quarter of 2017 showed that the economy grew at an annualized rate of 2.6%, more or less in line with consensus expectations. Consumer spending rose by 2.8%, driven by expenditure on durables (despite previous data suggesting weakness in auto sales over the quarter), which made up for more modest spending on services. Business investment remained elevated, while inventories and trade only had a limited impact. Though the overall second-quarter performance marked a healthy pickup from the tepid 1.2% figure seen in the first quarter, the average growth rate over the first half of 2017 showed little sign of breaking out from the modest trend of roughly 2% seen in recent years.

Second-quarter corporate earnings also came in generally upbeat, pointing to robust growth even after allowing for the exceptional performance of sectors like financials and energy, where idiosyncratic factors helped to drive earnings expansion. The strong earnings season helped US stocks to maintain their momentum and saw equity markets post new highs. In addition, broad measures of the risk premiums for US corporate bonds fell close to or even, in a few cases, below their lowest levels since the global financial crisis.

The strength of the labor market was further underlined by July's non-farm payrolls report, which showed that the economy added 209,000 jobs during the month, comfortably ahead of consensus expectations. Along with an upward revision to June's already-robust number, the latest figures left average monthly job gains so far in 2017 at 185,000, close to the strong pace set in 2016. July's data pointed to hiring across a number of service industries, most notably restaurants and bars, which added 53,000 positions. The unemployment rate ticked back down to 4.3%, matching the lowest level for 16 years seen in May, and there was further evidence that the solid demand from employers was helping to attract more entrants into the workforce, as the labor participation rate moved up a tenth to 62.9%, close to the top of its recent range.

But, despite the tightness of the labor market, July's report once more gave little indication of any accompanying pressures on wages. A monthly rise of 0.3% in average hourly earnings left the annual rate at 2.5% for the fourth consecutive month. Broader inflation data painted a similar picture: core consumer price growth for July was 0.1% month-on-month—falling short of consensus estimates and marking the fourth consecutive monthly rise of 0.1%—to leave the annual rate unchanged at 1.7%. June's core personal consumption expenditures price index—the Fed's favored measure of price growth—also remained weak, as the year-on-year rate was unchanged at 1.5%.

For its July meeting, the Fed slightly amended its accompanying statement to acknowledge the softer inflation data, but emphasized its confidence in the outlook for the US economy. The language used by the Fed also gave further weight to the potential commencement of its plan for balance sheet normalization at its next meeting in September. Nevertheless, in light of the latest sluggish inflation figures and dovish comments by a number of Fed officials, there was increased skepticism among many market participants about whether policymakers would go ahead and implement another rise in interest rates before the end of the year, as indicated by the Fed's projections for monetary policy.

The US dollar's weakness extended into another month, making the US currency's performance against other major currencies over the first seven months of 2017 its worst start to a year for more than three decades. While a more hawkish tone from the ECB has fueled the US dollar's decline against the euro, other reasons for the dollar's depreciation have included the problems facing the Trump administration in advancing its legislative agenda. As the year has progressed, many market participants have assigned a much lower probability to the chances for success of measures that could significantly boost US economic growth, and have reined in their expectations about the extent to which the US dollar could be boosted by tighter monetary policy.

Asian Economies' Performance Indicative of Improved Global Economic Growth

Second-quarter gross domestic product (GDP) figures revealed that Japan had expanded for the sixth consecutive quarter, its longest run of growth in more than a decade. Annualized growth of 4% in the three months to June was much higher than expected, boosted by a strong rise in private consumption. This suggests that Japan's rising stock market might be improving sentiment among its consumers.

However, at its meeting in July, the Bank of Japan (BoJ) highlighted how far the country's economy still has to go to overcome deflationary pressures, as the central bank further reduced its inflation forecasts for the period up to early 2019. The move looked to have increased the chances that the BoJ would keep monetary policy extremely accommodative for a considerable time yet.

China's growth over the same period was 6.9%, unchanged from the first three months of the year, with the property sector a notable area of strength, as house prices continued to rise despite measures by the Chinese government to cool the country's housing market. The Chinese economy has also been boosted by increased demand from the rest of the globe, with manufacturing export growth in the high single digits for the first half of 2017, after a contraction in 2016. In July, a leading purchasing managers' index for Chinese factories—focusing on smaller, privately-owned businesses—showed solid growth in output and new orders. Though annual growth in Chinese retail sales slowed slightly in July, the rate of expansion remained comfortably above 10%.

After the unexpectedly rapid turnaround in monetary policy by the Bank of Canada—with July's increase in Canadian interest rates coming almost a year earlier than had been widely predicted only a few weeks earlier—the attention of market participants turned to Australia, where interest rates remained at record lows. Investors speculated whether the more hawkish tone from other central banks might spark a change in policy by the Reserve Bank of Australia (RBA). The change in sentiment was most apparent in currency markets, pushing the Australian dollar to its highest level against the US dollar in more than two years. However, at its meeting in early August, the RBA left interest rates unchanged, while comments from policymakers downplayed the significance of monetary policy elsewhere. Indeed, in its quarterly monetary policy bulletin, the Australian central bank downgraded its 2017 growth forecast, as data covering the second quarter showed that inflation remained extremely weak.

Nevertheless, the relatively strong performance of Japan and China, Asia's two largest economies, underlines the more positive picture in large parts of the global economy so far in 2017, even if the overall level of growth is steady rather than elevated. Against this background, we think that the divergences in the monetary policies of the major economies are likely to become more apparent, which could increase pressure on some central banks and magnify market volatility.

Eurozone Data Upbeat but ECB Keeps Monetary Policy Unchanged

Second-quarter GDP figures for the eurozone confirmed what earlier data had indicated, namely that the region's economy was expanding at an impressive rate, amid a broad rebound in confidence following setbacks for European populist political parties in various elections earlier in the year. Its solid performance over the three months to June helped to push year-on-year growth in the single-currency bloc up to 2.1%, the highest level since 2011. Confidence indicators were generally even stronger, with the European Commission's economic sentiment index rising to its highest point in a decade, and a leading measure of German business sentiment posting a record high in July for the third successive month. The improvement in conditions was further emphasized by labor market data, showing that unemployment in the region had fallen in June to a nine-year low of 9.1%, 1% down from a year earlier. Nevertheless, prices remained subdued, with annual headline inflation for June remaining at 1.3% for the second consecutive month—its lowest level of the year so far—and the reading for core inflation up a tenth at 1.2%.

Following the shockwaves caused by ECB President Mario Draghi's speech in June—where his unexpectedly hawkish tone sparked a rally in German Bund yields that by early July had pushed them up to their highest levels since the start of 2016—investors looked to the ECB's July meeting to provide further signals on monetary policy. Though nothing of significance emerged from the meeting on the timing of any potential scaling back of the ECB's bond purchasing program, many market participants remained convinced that such a move was not far away, given the positive economic data from the region, with the central bank's next meeting in September favored as the most likely time for an announcement. There were also no signs of concern from policymakers at the ECB's July meeting regarding any potentially negative effects of the recent rise in the euro, which had appreciated markedly in the wake of Draghi's speech. As a result, the single currency continued to make gains, and by the end of July had reached a two-and-a-half year high against the US dollar.

We would agree an adjustment in the ECB's monetary-policy settings looks likely to be made soon, as it would be surprising if the central bank continued on its current highly accommodative course for much longer, considering the stronger-than-expected recovery in the eurozone economy. But our view is that the start of any tapering of the ECB's bond purchases is likely to be delayed until 2018, and would perhaps be more gradually implemented than is widely expected, until policymakers can be more confident that inflation will return and remain close to their target of around 2%.

In contrast to the eurozone, data for the United Kingdom (UK) pointed to slower growth. A leading measure of confidence among UK consumers fell in July to its lowest level since immediately after the referendum decision by UK voters to leave the European Union (EU) in 2016. Although retail sales rose in July, the increase was driven by higher food costs, itself a result of the fall in the British pound since the referendum result. Warning that uncertainty about negotiations on the terms of the UK's departure from the EU was holding back business investment and household spending, the Bank of England (BoE) cut its 2017 growth forecast from 1.9% to 1.7%. At its July meeting, the BoE left interest rates unchanged, with its monetary-policy committee appearing to place less priority on inflationary pressures resulting from the British pound's depreciation, maintaining its view that UK inflation would peak at around 3% later this year.

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.