FIXED INCOME

Global Economic Perspective: September

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Perspective from Franklin Templeton Fixed Income Group

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Short-Term Concerns Mask Robust US Economic Fundamentals
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Further Evidence of Synchronized Recovery across the Global Economy
As more and more countries deliver positive economic news, it raises the question of how sustainable the current upturn in the global economy could be. At this stage, we are still inclined to view this development as a cyclical recovery, rather than anything more significant. Determining a particular inflection point for inflation remains problematic, given the persistent structural forces that have suppressed prices since the global financial crisis. However, we continue to foresee a global environment characterized by higher interest rates.

ECB Flags Tapering Amid Stronger Growth but Weak Inflation

We believe the European Central Bank (ECB) adeptly negotiated the first stage of a potentially precarious path ahead at its September meeting. Policymakers are now looking to reduce the level of monetary stimulus, which seems appropriate given the strength of economic activity. At the same time, ruling out any increase in interest rates while bond purchases are scaled back, in our view, signals ECB President Mario Draghi's determination to resist any political pressure to speed up the process of normalizing monetary policy. It also emphasizes his dovish inclination to await evidence of more sustainable inflationary pressures before contemplating any further major policy shift.

Short-Term Concerns Mask Robust US Economic Fundamentals

The issues that have dominated news cycles in recent weeks—North Korea, along with extreme weather in the southern United States—should not obscure the robust underlying fundamentals of the US economy, in our view. Though some short-term weather-related disruption is possible, the economy seems to be maintaining its path of moderately strong growth, aided by healthy contributions from consumer spending and business investment. These conditions have continued to allow the Fed to move further toward its goal of normalizing monetary policy, after policymakers left interest rates unchanged in September, but maintained their forecast of a rate hike before the end of the year. We believe the Fed's decision to begin downsizing its balance sheet in October is likely to have only a marginal impact on the economy and financial markets.

Though market activity was somewhat subdued due to the traditional lull during August, a series of events—ranging from geopolitics to adverse weather—increased investor demand for the perceived safe haven of US Treasuries. Tensions between North Korea and the United States and its allies rose after several missile and nuclear tests by the North Korean regime, including one projectile that passed over northern Japan. The increasingly strident rhetoric from both sides and absence of consensus among major powers on how to respond to North Korea's actions increased uncertainty, and by early September benchmark Treasury yields had fallen to their lowest level so far this year.

The US states of Texas and Louisiana were hit by Hurricane Harvey in late August, with severe flooding particularly affecting Houston, the fourth-largest US city and the capital of the country's energy industry. In the aftermath, as many as a third of US oil refineries, many of which are located in the area around Houston, were estimated to have been impacted by flooding or supply disruptions. While the immediate impact was evident in higher wholesale gasoline prices, the overall effect on US economic growth appeared likely to be limited. Past experience suggested any short-term setback could be offset by increased expenditure in the months ahead, as infrastructure is rebuilt and economic activity rebounds. Nevertheless, with Hurricane Irma causing extensive damage across the state of Florida in early September, the potential for further weather-related disruption to the economy during the third quarter remained in focus.

One of the other issues that had been overshadowing the Treasury market in recent months was temporarily resolved, after US President Donald Trump agreed to provide a short-term increase in the country's debt ceiling, and at the same time postponed a deadline to pass a budget. The president's decision appeared to have been triggered by the need to avoid any shutdown of US government services that could hinder hurricane relief efforts.

In spite of these concerns, data elsewhere signaled the US economy maintained its robust footing. The estimate for annualized second-quarter 2017 growth was revised up from 2.6% to 3.0%—its quickest rate of expansion since the start of 2015—due to higher levels of consumer spending and business investment than initially thought. This pattern of a stronger-than-expected contribution from US consumers was reflected in July's retail sales report, which not only came in well ahead of consensus expectations, but also included significant upward revisions to the weak figures seen in May and June. The positive backdrop meant consensus forecasts for third-quarter growth remained moderately strong, in the range of 2.5%–3.0%, even after the weather-related disruptions.

Though the 156,000 jobs added in August's labor market report fell short of the figure predicted in consensus forecasts, any disappointment was muted by the historical tendency of data in August to be adjusted at a later date, with the initial level of hiring revised higher in five of the last six years. Nevertheless, combined with downward revisions to June's and July's payrolls, the August data were sufficient to push the unemployment rate off its 16-year low of 4.3% and back up to 4.4%. Hiring gains in manufacturing were a notable highlight, with the number of positions added matching the highest monthly total in four years. The robust conditions in US factories were underlined by the August reading for the Institute for Supply Management's purchasing managers' index (PMI), which climbed to its highest level in six years.

However, inflation readings showed no sign of breaking out of the passive trend of recent months. July's core personal consumption expenditures price index—the Fed's favored measure of inflation—managed only a 0.1% monthly rise, taking the annual rate down one-tenth to 1.4%. These figures were also replicated at the headline level. July's Consumer Price Index painted a similarly weak picture, with respective monthly and annual gains of 0.1% and 1.7% held back by moderating housing costs and sharply lower cell phone charges. August's labor market report showed annual wage growth stuck at 2.5%, despite the consistently high level of job creation.

In seeking to explain why inflation—and particularly wage growth—has remained so tepid, it may be useful to consider the demographic structure of the US workforce. Research has suggested that as workers from the "baby boomer" generation with relatively high salaries have retired, they have been replaced by younger employees receiving lower wages, thereby suppressing the rise in paychecks. When like-for-like wage growth (for the same job) was analyzed, it appeared to be roughly in line with the corresponding point in previous economic cycles. In addition, as baby boomers retire, the labor force participation rate would normally be expected to decline, whereas in fact it has stayed relatively high as the labor market has tightened. This would indicate that new entrants and former workers have been attracted into the workforce, although often into lowly paid, and often part-time, positions. The conclusion may be that there is some way to go before the dampening effects of demographics on wages and inflation are fully worked through.

Further Evidence of Synchronized Recovery across the Global Economy

The recent indications of a synchronized recovery across the global economy have continued. A rally in industrial commodity prices pointed to rising demand from China, the world's largest consumer of such metals, many of which are integral to its construction of real estate and infrastructure. Official and independent PMIs for the Chinese manufacturing sector posted solid numbers in August, and both exceeded consensus expectations. Ahead of the next congress of the Chinese communist party in October, where President Xi Jinping will unveil his new leadership team, there have been indications that Chinese policymakers have increasingly shifted their emphasis away from potentially disruptive reforms aimed at reducing excessive debt levels, particularly among local governments, and toward stabilizing the level of economic growth. After the Chinese renminbi appreciated to its highest level in nearly two years against the US dollar, the country's central bank eased some restrictions on the currency, a signal that the Chinese authorities' concerns about capital outflows were easing.

Mexico is one of the countries where a turnaround in economic sentiment over the last 12 months has been most evident. In the second half of 2016, the Mexican economy faced multiple problems, including fears a Trump presidency would herald a more protectionist stance from the United States, the aftermath of a worldwide slump in oil prices and escalating inflation, the latter of which was exacerbated by a fall in the Mexican peso. In response to the threat from inflation, which in August of this year reached a 16-year high, Mexico's central bank sharply tightened monetary policy, increasing interest rates at seven consecutive meetings up to June.

Moreover, while the threat of protectionist measures has remained, the political problems of the Trump administration may have lowered the possibility of aggressive unilateral measures by the United States on trade. The first two rounds of talks between the United States, Canada and Mexico—the member countries of the North American Free Trade Agreement—on reforming the agreement have so far been relatively uneventful, even if they are still at an early stage. The generally more positive backdrop for Mexico was highlighted by its central bank, which in August increased growth forecasts for 2017 and 2018, as well as stating its belief inflation had peaked. The change in sentiment has seen the Mexican peso climb back to levels last seen in mid-2016 against the US dollar, making it one of the world's best-performing currencies this year.

After a surprise switch to a more hawkish stance in its monetary policy in previous months, the Bank of Canada (BOC) once more caught investors off-guard by following up July's interest-rate rise with another hike in September, a month earlier than expected by consensus market forecasts. The central bank cited stronger-than-expected economic data—in the first half of this year, Canada's gross domestic product (GDP) expanded by the most in 15 years—in support of its view that the country's growth was becoming more broadly based and self-sustaining. Following the BOC's decision, the Canadian dollar added to its gains against the US dollar, posting a two-year high.

As more and more countries deliver positive economic news, it raises the question of how sustainable the current upturn in the global economy could be. At this stage, we are still inclined to view this development as a cyclical recovery, rather than anything more significant. Determining a particular inflection point for inflation remains problematic, given the persistent structural forces that have suppressed prices since the global financial crisis. However, we continue to foresee a global environment characterized by higher interest rates.

ECB Flags Tapering amid Stronger Growth but Weak Inflation

During August and into September, data from the eurozone remained upbeat, with an already solid second-quarter performance revised even higher, pushing year-on-year growth to 2.3%, the quickest pace since the region's debt crisis of 2011–2012. Business and consumer surveys pointed to continued momentum in the third quarter, keeping the single-currency bloc on course to potentially deliver its strongest calendar year of growth in a decade. Despite these signals, inflation showed little sign of life. An uptick in annual headline inflation in August was primarily driven by rising energy prices, and core inflation remained stuck at 1.2% for a second consecutive month.

The progress clearly underway in the eurozone's economy heightened speculation about a tapering of the ECB's quantitative easing (QE) program. This sentiment was most noticeable in currency markets, where the euro continued to move higher against many other major currencies. At first, market participants looked to a speech being given by ECB President Draghi at the annual Jackson Hole symposium of central bankers late in August, seeking hints about a change in monetary policy. When President Draghi's remarks there concentrated on other topics, attention turned to the ECB meeting in early September. Here, policymakers confirmed they had initiated discussions on how to wind down the program of bond purchases. However, they also indicated a more detailed announcement on the subject would follow, most likely at their next meeting in October. The rise in the euro—seen as likely to prove a drag on inflation—was described by the ECB as a "source of volatility" that required monitoring. But in the absence of any suggestion that the currency's appreciation would delay a tapering of bond purchases, the single currency's rally—which by the end of August had taken it above US$1.20 for the first time since the start of 2015—resumed, following a brief pause in the run-up to the ECB meeting.

The difficulty for the ECB in managing market expectations on monetary policy in the face of stronger economic growth was evident elsewhere in President Draghi's remarks, as he repeatedly stressed the need to keep the region's interest rates at current levels while the central bank winds down its QE program. In response, market participants scaled back their bets on an interest-rate hike in 2018. The eurozone has undergone a loosening of the traditionally positive correlation between growth and inflation also seen in many other parts of the global economy. The latest set of macroeconomic forecasts from the ECB underlined this trend. Partly due to the stronger euro, policymakers slightly reduced their inflation forecasts for 2018 and 2019, while at the same time upgrading GDP estimates for the current year from 1.9% to 2.2%. Nevertheless, President Draghi re-iterated his belief that by 2020, inflation will have moved in line with the ECB's target of close to but below 2%.

All in all, we believe the ECB adeptly negotiated the first stage of a potentially precarious path ahead at its September meeting. A highly accommodative stance has clearly boosted domestic demand, and policymakers are now looking to reduce the level of monetary stimulus, which seems appropriate, given the strength of economic activity. By downplaying the euro's strength, they suggested any potential deflationary effects caused by the rise in the single currency are likely to be limited, barring an outsized further appreciation. At the same time, ruling out any increase in interest rates while bond purchases are scaled back, in our view, signals President Draghi's determination to resist any political pressure to speed up the process of normalizing monetary policy. It also emphasizes his dovish inclination to await evidence of more sustainable inflationary pressures before contemplating any further major policy shift.

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