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Global Economic Perspective: October

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Perspective from Franklin Templeton Fixed Income Group

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Drivers of Solid US Economic Expansion Remain in Place

Recent data have supported our view that the drivers of the US economy's solid expansion remain in place, and should allow the US Federal Reserve (Fed) to move further toward its goal of normalizing interest rates. Some data releases have clearly been skewed by the recent major hurricanes, but we feel any negative impact on the economy is likely to be transient and outweighed by demand arising from reconstruction. Persistently low inflation has shown little sign of picking up, although it should be remembered that the United States shares this characteristic with many other major economies. Structural factors may mean prices take longer to respond to the current higher levels of activity than would normally be expected at this point in the economic cycle.

Backdrop Still Upbeat across Most of the Global Economy

We would broadly agree with the International Monetary Fund's (IMF's) recent assessment of a healthier global economy, though it is difficult to envisage politicians using the current expansion to deliver reforms to address the problems such as poor productivity and low wage growth facing many parts of the world. A more likely scenario, in our view, is one whereby the current cyclical upturn continues, along with the structural restraints that could keep global growth from accelerating too much further.

German Election Shows Populism Retains Influence in European Politics

The German election result illustrated our view that, despite the results of the French and Dutch elections earlier this year, populism in Europe remains politically relevant. Though it is important not to overstate the situation, the level of support for the main German right-wing populist party reflects a significant protest vote, which could have an influence on German Chancellor Angela Merkel's approach as she looks past her election victory. To ensure populist parties do not increase their share of the vote, the German leader is likely to closely focus on maintaining the economy's robust growth and to carefully consider the implications of any steps to promote greater political and fiscal union across the European Union (EU).

Drivers of Solid US Economic Expansion Remain in Place

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Persistently low inflation has shown little sign of picking up, although it should be remembered that the United States shares this characteristic with many other major economies. As we have argued before, structural factors may mean prices take longer to respond to the current higher levels of activity than would normally be expected at this point in the economic cycle.

September saw a turnaround in sentiment among market participants about the likelihood of another rise in US interest rates before the end of the year, which was also reflected in moves in the Treasury market. Initially, investors were skeptical about any further tightening of monetary policy in coming months, amid escalating tensions between North Korea and the United States, further soft inflation data and uncertainty about the potentially negative effects of hurricanes Harvey and Irma on the economy. Early in September, federal funds futures declined and suggested only about a 30% probability of an interest-rate hike in December. Benchmark Treasury yields fell close to 2%, their lowest level thus far this year.

But gradually, worries about geopolitical tensions and the impact of adverse weather subsided. Investors began to focus once more on the positive domestic economic backdrop, along with the increasingly encouraging signals coming from many other parts of the global economy. At the Fed's September meeting, policymakers stuck with their forecasts for one more interest-rate rise this year and three in 2018, indicating their willingness—at least, for the time being—to look past persistent low inflation. As widely expected, they also announced that in October they would begin to reduce the Fed's balance sheet from the expanded size reached during previous quantitative easing programs. A speech the following week by Fed Chair Janet Yellen giving a bullish assessment of the economy, as well as a later one by President Donald Trump outlining ambitious plans for tax reforms, continued to build expectations of further monetary tightening.

In response, both fed funds futures and Treasury yields moved steadily higher during September and briefly advanced once more following the labor market report for the month, as investors initially zeroed in on wage growth of 2.9%, the fastest rate since 2009. But with the report showing a loss of 33,000 payrolls, the Bureau of Labor Statistics (BLS) cautioned that some of the data in the report might have been skewed by the impact of the hurricanes. Nevertheless, the BLS's view was that data measuring the unemployment rate—which dropped to a new multi-year low of 4.2%—remained unaffected. By early October, fed fund futures were indicating around a 90% probability of a rise in interest rates by the end of the year. Benchmark Treasury yields also climbed, reaching levels last seen at the start of July, while the yield on the policy-sensitive two-year Treasury note hit its highest point since the global financial crisis.

Surveys generally underlined the solid outlook, suggesting weather-related disruption to the economy had been limited to a short period. The Institute for Supply Management's (ISM's) purchasing managers' index (PMI) covering services in September came in significantly higher than consensus forecasts, registering its highest reading since 2005, with business activity and new orders notable areas of strength. Additionally, the part of the index covering prices showed a fourth consecutive monthly rise, to its highest level in more than five years.

The equivalent PMI for manufacturing also posted a strong reading for September, and here the employment component of the index stood out, registering a six-year high. Some evidence of hurricane-related effects on supply chains was evident in the sub-index for prices, which showed a sharp rise. Elsewhere, an index measuring expectations for future sales, investment and hiring among chief executive officers (CEOs) edged up over the third quarter, to its highest level since 2014. In the survey, CEOs identified the US tax system as the biggest headwind for the United States relative to other major economies.

Though gauging the possibility of political agreement on a fiscal stimulus package remained difficult, any potential introduction of such legislation still appeared some way off. But another factor that could have a significant influence on the trajectory of US monetary policy drew closer, as President Trump's announcement of his proposed candidate to succeed Janet Yellen as Fed chair in February 2018 will be revealed in the coming weeks. Combined with the unexpectedly early departure of the Fed's vice chair, Stanley Fischer, and the three pre-existing vacancies out of the seven seats on the Fed's board of governors, there has remained a high degree of uncertainty about the future composition of the central bank's leadership.

President Trump had already nominated one candidate for the Fed's board, Randal Quarles, whose suitability was duly confirmed by the US Senate in early October. At his Senate confirmation hearings, Mr. Quarles indicated he favored a lighter regulatory touch in financial services. His views put him somewhat at odds with current Fed Chair Yellen, who recently argued that tighter regulations introduced in the wake of the global financial crisis should be left in place, but served to underline that de-regulation, as well as fiscal reform, could provide a future tailwind for the economy.

Backdrop Still Upbeat across Most of the Global Economy

The optimism surrounding the global economic recovery was apparent in an upbeat speech in early October by the head of the IMF, Christine Lagarde. She suggested the IMF would probably lift its forecasts for global growth and employment in its next round of estimates, while also alluding to more favorable assessments of financial stability and public finances. The IMF expects all of the G20 countries to grow this year, the first such synchronized expansion since 2010. The IMF head encouraged countries to use this period to make reforms that could help sustain growth over the longer term, since, she argued, support for such measures would likely be harder to achieve during any subsequent downturn.

In Japan, Prime Minister Shinzo Abe called a snap general election for late October, in what was widely seen as a move to capitalize on his healthy lead in opinion polls and to secure a further mandate for current monetary and fiscal policies. The main opposition to the ruling Liberal Democrat Party (LDP) appeared likely to come from Tokyo's popular governor Yuriko Koike, who launched her new Party of Hope just before the election was called. The prospect of a shake-up in the Japanese political landscape increased when the center-left Democratic party—previously the main opposition to the LDP—announced it would not field any candidates in the election, freeing its representatives in the Japanese parliament to seek nominations from Ms. Koike's party. However, the chances of her party gaining significant support in the election tailed off when the Tokyo governor confirmed her reluctance to stand for parliament herself, increasing uncertainty about the opposition's strategy.

The leading non-US benchmark for oil prices reached its highest level for more than two years, as Turkey threatened to disrupt supplies from Kurdish oilfields in northern Iraq in response to the autonomous Kurdish region's referendum on independence. The price rise occurred with energy demand across both developed and emerging economies elevated by stronger global economic growth. On the supply side, production cuts agreed by OPEC (Organization of the Petroleum Exporting Countries) and other major producers have proved more effective than originally thought by many participants. Nevertheless, US benchmarks were less volatile, as US shale oil production continued to increase in response to higher global prices, while US oil exports reached record levels.

China's credit rating was downgraded one notch to A+ by ratings agency Standard & Poor's (S&P), which cited increased economic and financial risks, following the significant rise in the country's debt levels since the global financial crisis. The move brought S&P into line with the other major ratings agencies. PMIs for the Chinese manufacturing sector were mixed in September, with a strong showing from an official survey focusing on larger, state-owned companies and somewhat weaker results from an index concentrating on smaller private firms.

We would broadly agree with the IMF's picture of a healthier global economy, though it is more difficult to envisage politicians using the current expansion to deliver reforms to address the problems such as poor productivity and low wage growth facing many parts of the world. A more likely scenario, in our view, is one whereby the current cyclical upturn continues, along with the structural restraints that could keep global growth from accelerating too much further.

German Election Shows Populism Retains Influence in European Politics

As the European Central Bank's discussions on how to wind down its quantitative easing program continued—ahead of a formal announcement expected at the end of October—policymakers were careful to emphasize their view that it remained too early to contemplate any increase in interest rates. Surveys of business activity suggested further strong growth across the single-currency region in September, and the European Commission's economic sentiment gauge hit its highest level in 10 years. But the mixed economic picture was underlined by the same month's inflation report, showing annual price rises below consensus forecasts at the headline level and a slight decline in core inflation.

Germany's elections saw a reduced vote for the two parties in Chancellor Angela Merkel's previous ruling coalition, and unprecedented gains for the country's main right-wing populist party, the Alternative für Deutschland (AfD). A new coalition government led by Chancellor Merkel still seemed the most likely outcome, although negotiations between the various parties looked set to take some time, mainly due to the difficulties of accommodating the opposing views of the junior partners in the proposed coalition, the economically liberal Free Democratic Party (FDP) and the Greens. In previous German governing coalitions, the country's finance minister has traditionally been provided by the second-largest party in the coalition—in the current negotiations, the FDP—so there was also speculation that prevailing German political opinion was likely to become more resistant to any future proposals from fellow EU members to reform the region's financial markets through a mutual underwriting of eurozone debt.

The German election result illustrated our view that, despite the results of the French and Dutch elections earlier this year, populism in Europe remains politically important. Though it is important not to overstate the situation—realistically, the AfD party is unlikely to have a significant influence over policy in Germany in the short term—the level of support for the German right-wing party reflects a significant protest vote, which could have an influence on Chancellor Merkel's approach as she looks past her election victory. To ensure populist parties do not increase their share of the vote, the German leader is likely to closely focus on maintaining the economy's robust growth and to carefully consider the implications of any steps to promote greater political and fiscal union across the EU.

A constitutional crisis erupted in Spain, as longstanding calls from separatist politicians in the region of Catalonia for independence intensified after the Spanish government's attempts to prevent Catalans voting in a referendum on the issue sparked violent clashes. Though turnout in the referendum was only around 40%, voters overwhelmingly favored independence, and it was unclear to what extent the tough response from the Spanish authorities may have galvanized additional support for a breakaway. Amid rising concerns about whether the crisis would escalate further, some of the region's largest banks and corporations announced they would relocate their headquarters from the main Catalan city of Barcelona to the Spanish capital Madrid. Catalonia's economy is around the same size as Portugal's and is of critical importance to Spain, making up a fifth of the country's gross domestic product. Any move by Catalan separatists in the region's parliament to unilaterally secede seemed likely to spark a severe economic crisis, not least because it could threaten the region's membership of the EU and eurozone.

Portugal received a vote of confidence from S&P, which upgraded the country's bonds to investment-grade status. Since coming to power at the end of 2015, a minority socialist Portuguese government has overcome initial skepticism among market participants and successfully introduced measures to reduce its budget deficit and reform the country's banking system, providing greater stability for investors. In turn, this has allowed the Portuguese economy to become one of the biggest beneficiaries of the eurozone's robust recovery, with the IMF forecasting 2017 could be the country's best year of growth in more than 20 years. The conditions have fueled a rally in Portugal's sovereign bonds so far this year, although they remain the second-highest yielding bonds in the eurozone, behind those of Greece.

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