FIXED INCOME

Global Economic Perspective: November

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Perspective from Franklin Templeton Fixed Income Group

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Economic Backdrop Has Remained Supportive as Fed Chair Nomination Suggests Policy Continuity

The economic backdrop has remained supportive, both in the United States and globally, and should allow the US Federal Reserve (Fed) to continue raising interest rates at a measured pace, in our view. Jerome Powell's nomination as Fed chair points to continuity in monetary policy in the near term, although coming appointments to other key positions at the central bank could increase uncertainty in this area further down the line. The implementation of an expansionary fiscal package aimed at boosting growth at this relatively late stage in the economic cycle would likely also move the dial on monetary policy, but we would caution that the prospect of agreement on such legislation remains some way off and may well prove too difficult to achieve.

Dovish Central Banks Still Main Driver of Markets Despite Solid Global Economic Growth

Solid global economic growth appears likely to continue, we believe, with nearly all the major countries on course to sustain their expansion. Yet past predictions of rising interest rates have consistently proved premature, largely due to a general absence of inflationary pressures, resulting in a dovish tilt to monetary policy among the main central banks. Investors' perceptions about the intentions of these central banks, rather than economic fundamentals, are set to remain the central driver of markets. Uncertainty created by factors such as geopolitics may only serve to convince policymakers to maintain a looser monetary stance than might otherwise be expected by economic conditions.

ECB Maintains Dovish Stance as Weak Inflation Offsets Brighter Economy

The eurozone's cyclical recovery should continue, in our view, with increasing confidence among consumers and businesses in the region boosting spending, and a further lift from a healthy global economic environment. Despite this upbeat outlook, as long as inflation remains weak, a significant shift in European Central Bank (ECB) policy is hard to envisage. ECB President Mario Draghi's repeated insistence that the central bank will not raise interest rates before ending quantitative easing (QE) underlines how far away such a move remains. Since his term as ECB president is not due to expire until late 2019, the prospect of any reconsideration of interest-rate policy in the near term seems slight.

Economic Backdrop Has Remained Supportive as Fed Chair Nomination Suggests Policy Continuity

The economic backdrop has remained supportive, both in the United States and globally, and should allow the Fed to continue raising interest rates at a measured pace, in our view. Jerome Powell's nomination as Fed chair points to continuity in monetary policy in the near term, although coming appointments to other key positions at the central bank could increase uncertainty in this area further down the line. The implementation of an expansionary fiscal package aimed at boosting growth at this relatively late stage in the economic cycle would also probably move the dial on monetary policy, but we would caution that the prospect of agreement on such legislation remains some way off and may well prove too difficult to achieve.

Two issues have been prominent across news headlines in the United States. The first was the nomination of Jerome Powell by President Trump as the incoming chair of the Fed, a choice widely seen as representing a continuation of the status quo in terms of the central bank's policies. Jerome Powell was first appointed to the Fed's seven-person Board of Governors in 2012, and over that time he has never dissented from the Federal Open Market Committee's (FOMC's) decisions on monetary policy. Though Powell is thought to favor a lighter touch on financial regulation than current Fed Chair Janet Yellen, his nomination provided re-assurance to market participants that her relatively predictable approach and dovish tendencies on monetary policy would be maintained during the transition of the Fed's leadership. There was little sign of any market reaction in the run-up to the announcement of Powell's nomination.

However, a few days later Bill Dudley—the president of the Federal Reserve Bank of New York (which is an important contributor to financial regulation) as well as being a member of the FOMC—announced he would bring forward his retirement to mid-2018, calling attention to the current and forthcoming vacancies in several other key positions at the Fed. Uncertainty about the views of the nominees who will fill these vacancies has left open the possibility that the current tone of Fed policymaking could shift significantly in 2018.

The other issue that was never far from the headlines was tax reform, as Republican legislators submitted a package of proposals. The most striking element was a significant cut in the headline tax rate for US corporations, which is relatively high in comparison to the rate in many other countries. Other mooted policies included a one-off tax on profits retained overseas by US companies, plans to combat their use of low-tax jurisdictions and limits on the deduction of debt interest from their tax bills. Individuals were promised a simplification of tax bands and an increase in the threshold for the highest tax bracket, in return for losing the right to deduct state and local tax from federal taxes, as well as the loss of mortgage interest deductions on more expensive housing. According to Republican party projections, the changes would add US$1.5 trillion to the federal deficit over 10 years.

Regarding economic data, the positive tone that has been in place for several months continued, with third-quarter gross domestic product (GDP) figures coming in ahead of consensus estimates at an annualized rate of 3%, marking the first increase of at least 3% in consecutive quarters since 2014. That the pace of growth was broadly maintained was impressive, considering the disruption caused by hurricanes Harvey and Irma during the period. September's retail sales numbers were inflated by hurricane-related gains, but even allowing for these one-offs, this and other reports pointed to a very strong final month for third-quarter consumer spending.

There were signs the economy's momentum could be maintained into the fourth quarter. Both of the purchasing managers' indexes (PMIs) from the Institute for Supply Management remained strong in October. The non-manufacturing PMI, which tracks construction and mining as well as services, rose to its highest level since 2004, and while the PMI covering manufacturing dipped slightly from the previous month's 13-year high, it continued to indicate robust expansion, with particular strength in new orders. October was another healthy month for auto sales, though the rate of vehicles sold pulled back somewhat from September's rapid, hurricane-distorted pace.

October's labor market data reverted to the relatively familiar picture of solid job creation accompanied by lackluster wage growth. Continuing weather-related disruptions to the measure were evident in the 261,000 rise in payrolls, which was well below consensus expectations, but the shortfall was fully offset by upward revisions of 90,000 for the previous two months. The unemployment rate fell to 4.1%, its lowest level since 2000, while the labor participation rate dropped to 62.7%, suggesting the number of people re-entering the workforce might be dwindling, despite the tightness of the market. But after surging in the previous month, most likely due to the effects of the hurricanes, average hourly earnings were unchanged in October, pushing annual wage growth down to 2.4%. Broader measures of inflation also remained weak, with September's core personal consumption expenditures price index—the Fed's favored measure of inflation—stuck at 0.1% month-on-month for the fifth consecutive report, and the annual rate unchanged at 1.3%.

Toward the end of October, strong domestic economic data briefly pushed benchmark US Treasury yields to their highest level since March. But a combination of factors—including a more dovish-than-expected update from the ECB, perceptions that Fed Chair Yellen's dovish tilt to Fed policy would likely be maintained by Jerome Powell and the absence of any sign of pricing pressures—saw them dip once more back into the trading range that has held for much of 2017. While we continue to believe interest rates are biased to rise, it remains difficult to be more precise as to the timeframe for such a development.

Dovish Central Banks Still Main Driver of Markets Despite Solid Global Economic Growth

In Asia, the Chinese Communist Party congress provided further evidence of party head and President Xi Jinping's consolidation of power. Previous tradition had seen a successor identified at the gathering after the head of the party had served one five-year term, prior to a transfer of power at the end of the leader's second five-year term. But with no signs of any such individual emerging, there seemed little to bar Xi from extending his tenure in the post beyond 2022. The Chinese leadership had been widely expected to prioritize economic stability ahead of the congress, and figures showing third-quarter growth of 6.8% year-on-year confirmed this goal, leaving the economy on course to exceed the official target of around 6.5% growth for 2017 as a whole.

In Japan, Prime Minister Shinzo Abe's ruling Liberal Democratic party scored a resounding election victory against a divided opposition, extending the mandate for his economic policies, as well as providing him with an opportunity to push through constitutional reform. In the wake of his victory, the prime minister called on Japanese companies to raise wages by 3% as part of his efforts to fuel higher consumption and inflation. Wage growth has declined since 2015, despite Japan's unemployment rate falling to its lowest level for 23 years.

Oil prices spiked to a two-year high after Saudi Arabia launched a country-wide probe into corruption, detaining numerous high-profile individuals, including prominent businessmen and members of the ruling al-Saud family, as well as current and former ministers. It remained unclear to what extent Crown Prince Mohammed bin Salman—seen as the de facto ruler of the country—was using the probe as a political tool to increase his control over the kingdom, while he continues to pursue a radical economic reform program. At the same time, tension between Saudi Arabia and Iran ratcheted up even further, after the interception of a missile said by Saudi Arabia to have been fired at its territory by Iranian-supported forces in Yemen. The latest rise in oil prices took gains in the Brent crude oil benchmark to 40% since June.

Even before the events in Saudi Arabia, the positive backdrop for oil prices had been building, due to stronger growth across the global economy. We believe this solid economic growth appears likely to continue, with nearly all the major countries set to sustain their expansion. Yet as the past few years have shown, predictions of rising interest rates have consistently proved premature, largely due to a general absence of inflationary pressures, resulting in a dovish tilt to monetary policy among the main central banks.

Investors' perceptions about the intentions of these central banks, rather than economic fundamentals, are likely to remain the central driver of fixed income markets. Uncertainty created by factors such as geopolitics may only serve to convince policymakers to maintain a looser monetary stance than might otherwise be expected by economic conditions.

ECB Maintains Dovish Stance as Weak Inflation Offsets Brighter Economy

As had been widely expected, at the ECB's meeting in late October, policymakers outlined their plans to reduce the monthly bond purchases carried out by the central bank as part of its QE program. A reduction from €60 billion to €30 billion per month was scheduled for the start of 2018, but the dovish tone of ECB President Mario Draghi's accompanying comments—emphasizing that the QE program could be extended beyond September 2018, and giving no indication of an end date—came as something of a surprise to market participants, sparking a rally in eurozone bonds and a moderate selloff in the euro.

As well as indicating the reductions would be concentrated on its purchases of government (rather than corporate) bonds, the ECB subsequently provided details of its previously purchased securities that are set to mature over the next 12 months. As the proceeds from these redemptions are reinvested by the ECB, they will offset some of the recently announced reduction in the central bank's purchases—perhaps by as much as a half overall—although with relatively few redemptions in the first quarter of 2018, the reinvestment is scheduled to take place mainly in the second and third quarters of the coming year.

Growth in the eurozone over the third quarter beat consensus expectations, resulting in an annual increase of 2.5%, a slight acceleration from the rate of 2.3% seen in the previous quarter. In September, the rate of unemployment in the single-currency area dipped below 9%, a level not seen since 2009, but the initial estimate of inflation for October was weaker than widely expected. As ECB President Draghi had earlier cautioned might be the case, headline inflation dipped as previous rises in energy costs dropped out of the calculations. Nevertheless, a decline in the cost of services reduced the annual rise in core inflation to 0.9%, its weakest reading in several months.

In another well-flagged move, the Bank of England (BoE) raised interest rates in the United Kingdom (UK) for the first time since the global financial crisis, following data showing third-quarter UK growth was a little higher than consensus forecasts. Explaining the rate hike, BoE Governor Mark Carney cited a record low level of unemployment, inflation above the BoE's target of 2% and the UK economy's reduced growth capacity, which policymakers believe has lowered the threshold at which it can expand without creating pricing pressures.

Nevertheless, with bodies including the International Monetary Fund warning that the negative effects of the UK's decision to leave the European Union (EU) were starting to weigh on the economy's long-term growth prospects, reaction among market participants to the BoE's signaling of further interest-rate rises was somewhat skeptical. There seemed little sign of any significant progress in the negotiations on the terms of the UK's departure, and the immediate prospects for a breakthrough—on issues such as the UK's outstanding financial obligations to the EU and a transition deal for the period following the March 2019 deadline for the UK to leave—seemed slim.

Elsewhere in Europe, Spain's constitutional crisis rumbled on, as the central government looked to re-assert its authority over Catalonia. Fresh elections in the region were scheduled for December, but seemed unlikely to provide any lasting solution. With most of the Catalan leadership either under arrest or having fled abroad, some polls indicated the crackdown by the Spanish government had increased support for independence among voters in the region.

In Italy, regional elections in Sicily saw a coalition of center-right parties gain the largest share of the vote, ahead of the populist Five Star Movement. With national elections due to take place during the first half of 2018, Five Star's failure to win in a region seen as one of its strongholds was characterized by some commentators as evidence the party's appeal had peaked. A poor performance in Sicily by the governing center-left Democratic party added to tentative signs of a shift in sentiment among Italian voters.

The eurozone’s cyclical recovery should continue, in our view, with increasing confidence among consumers and businesses in the region boosting spending, and a further lift from a supportive global economic environment. The current expansion seems durable and well-distributed among the member states. Despite this upbeat outlook, as long as inflation remains weak (which consensus forecasts for 2018 indicate is likely), a significant shift in the ECB’s policy is hard to envisage. ECB President Mario Draghi’s repeated insistence that the central bank will not raise interest rates before ending QE underlines how far away such a move remains. Since his term as ECB president is not due to expire until late 2019, the prospect of any reconsideration of interest-rate policy in the near term seems slight.

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