FRANKLIN TEMPLETON INVESTMENTS

Beyond Bulls & Bears

# Global Economic Perspective – April

April 22, 2014

**Franklin Templeton Fixed Income Group®**

### US Interest Rates Likely To Remain Low

There have been a number of signs that the US economy is emerging from the small slump in activity seen in the last weeks of 2013 and in the early part of 2014, when extreme weather may have distorted data. The growth estimate for the final quarter of 2013 was revised upward to 2.6% from an earlier reading of 2.4%, thanks largely to a better reading for personal consumption. And while gross domestic product (GDP) growth for the first quarter of 2014 may be lower because of the weather-related slump, observers are already looking out to the second quarter. Many, including us, believe the coming weeks should show the US economy regaining its stride.

Recent statistics are already pointing toward a sprightlier economy, with consumer spending stepping up a bit in February and March as incomes increased, while jobless claims have continued to fall. On the corporate side, the situation is also brightening, in our view. The Institute for Supply Management (ISM) Manufacturing Index rose in February and again in March to well above the 50 mark that separates contraction from expansion. Manufacturers said orders were picking up, which could lead to more positive news in the coming months. The ISM reading for activity in the services sector also accelerated in March.

While the US economy has continued to expand and will likely sooner or later push the US Federal Reserve (Fed) closer to so-called "normalization" of its accommodative monetary policies, Fed Chair Janet Yellen is generally thought to have been too precise when she suggested in mid-March that the Fed could start to raise interest rates six months after it had wound down its quantitative easing (QE) program. This comment was taken by some as suggesting we could see rate hikes sometime in spring 2015, causing an immediate, albeit short-lived, wobble in financial markets. Soon after, however, Yellen struck a different tone, stressing that loose monetary policy was "still needed and will be for some time to come" given that there was considerable slack in the US labor market.

In essence, Fed policy is now arguably much more nuanced than it was back in December 2012 when Yellen's predecessor, Ben Bernanke, announced a fall in the unemployment rate to 6.5% as a threshold for tightening monetary policy. This threshold possibly made sense at the time if the expectation was that a tighter job market would trigger higher inflation. But although the headline unemployment rate is now close to 6.5%, inflation is low (core personal consumption expenditure, a key measure for the Fed, came in at an annualized rate of just 1.1% in February). The Fed appears to be focused now on a dashboard of data that delves deep into job statistics. The dashboard includes labor force participation, wage growth and long-term unemployment rates, as well as statistics on quitting and hiring and the so-called "U6" unemployment rate (which includes those workers who are part-time purely for economic reasons and, at 12.7% in March, is much higher than the official jobless rate). While there has been improvement, some of these gauges are still weaker than their pre-recession levels. Yellen stated that "the dial on virtually all of those things is moving in the direction of improvement," but she also

pointed to the problems of long-term unemployment and low wage growth as reasons for believing that extraordinary monetary policy was still needed. She also pointed to the decline in the labor force participation rate (from 66% in 2008 to 63% today, according to the Bureau of Labor Statistics) as signaling a lack of demand in the economy.

While we wait for further improvement in readings on the Fed's dashboard, Yellen's apparent assurance that the central bank will maintain accommodative monetary conditions for some time to come in the absence of inflationary pressures is echoed in bond markets, which have remained relatively placid. Indeed, benchmark 10-year US Treasury yields had drifted up to 2.80% at the beginning of April from 2.60% a month earlier, but were still below the 3% rate they briefly reached in late December 2013 after the Fed announced plans to taper its asset-purchase program. In our view, factors keeping yields low include rates of growth (and inflation) in the US that have been relatively pallid for this point in the economic cycle, signs of weakness in large emerging markets, and geopolitical tensions from the South China Sea to Crimea. There is also continued demand for US bonds—not only because of their status as perceived "safe havens" in a world of uncertainties, but also because they have continued to offer higher yields than their German or Japanese counterparts. In sum, our view is that the bond markets have been signaling subdued expectations for US growth and inflation. Although interest-rate expectations currently remain well anchored, the acceleration in growth that we expect to see in the coming months is likely to lead to a gradual increase in bond yields in the months ahead. But having weathered the turbulence that emerged in the middle of last year over the Fed's intentions, it is to be hoped that investors are prepared for a possible inflection in the Fed's dovish monetary policy stance should economic data show the US economy to be on a firmer footing after the winter slowdown.

## Japan Tries To Boost Inflation

With Institute of International Finance figures suggesting that there has been a significant rebound in portfolio inflows into emerging markets since February, investor confidence in these markets seems to be returning. We think the upturn in investor sentiment reflects a greater willingness to discriminate between countries according to their fundamentals, the fading of concerns connected with Fed tapering, and some less alarmist talk about China's prospects as it undergoes massive (but so far manageable) reform. Renewed stimulus

measures by the Chinese authorities to prop up growth and help ensure their target for this year's growth target of about 7.5% is reached have also helped calm investor sentiment somewhat.

Elsewhere, the Indonesian rupiah has recently rallied on better-than-expected growth, trade and inflation figures. Elsewhere in Asia, statistics out of countries like Singapore and South Korea have been largely upbeat. As in Indonesia, the slide in the Brazilian real had also been halted by March thanks to successive interest rate hikes. The tensions between Russia and the West over the former's annexation of Crimea have battered Russian assets, but the tensions have at least not escalated, and the situation's effects on financial markets outside Russia and Ukraine thus far have been contained, in our view. Turkish assets also rallied, even before the strong performance of Prime Minister Recep Tayyip Erdogan's party in local elections, as the country's current account deficit showed signs of narrowing, and GDP for the final quarter of 2013 came in at a relatively robust annualized rate of 4.4% compared to the fourth quarter of 2012.

The recent resilience of many emerging markets may indicate that they could potentially cope with future interest-rate "normalization" in the US and some appreciation in the US dollar over the medium term. Plenty of risks remain, of course, some of which are connected to upcoming elections in various countries. And even where appropriate policy adjustments have begun, in our opinion more work remains, especially in reform-shy countries like South Africa and India, if improved market expectations are to be satisfied.

But even as China slows, economies in Asia and elsewhere may also feel the impact of bold policy initiatives in Japan. On April 1, Japan's national sales tax was raised from 5% to 8%. A further hike of the tax to 10% is scheduled for October 2015. The rise of the sales tax has stirred painful memories of the last time it was raised, 17 years ago. Almost immediately after the 1997 increase, Japan plunged into a deep and lasting recession, leaving the country stuck in a deflation trap. The optimists point out that the last attempt to boost the sales tax coincided with the Asian financial crisis and a series of banking collapses in Japan itself. Japan, they say, is much better prepared this time around and the global economic backdrop is not so dire, while importantly the Bank of Japan has indicated it remains committed to very easy monetary policy to try and limit the negative consequences of the tax hike.

A rush by Japanese consumers to make large purchases before the tax increase could be seen in Cabinet Office figures that showed a year-on-year increase of 4.35% in retail sales in February and has helped boost corporate revenues in the past several months and has had the desired effect of pushing up inflation, but the last Tankan survey of Japanese business sentiment suggested that companies catering to Japanese consumers are not optimistic about prospects for the rest of this year. Surveys of sentiment in other sectors, however, have been more upbeat, with large Japanese corporations reporting higher earnings expectations—no doubt helped by moves to reform and potentially lower corporate taxes, along with other one-off supplementary spending measures that included steps to encourage corporate investment and employment, as well as handouts for low-income households. It is also possible that recent wage increases in some industries could help dent the effect of the sales tax rise.

It is not at all clear that the Bank of Japan will meet its goal of generating 2% inflation by early to mid-2015, especially as the pace of yen weakening has trailed off. If inflation does not move close to that target, the Bank of Japan—which has already vowed to buy enough longer-term government bonds to double the monetary base by the end of this year—may be tempted to buy even more assets, with a lot of the extra liquidity flowing into other countries. Thus, even as the Fed winds down its monthly asset-purchase program, it seems possible that global assets could continue to benefit from fresh injections of liquidity.

### European Outlook

The crisis provoked by Russia's annexation of Crimea loomed large throughout March and early April in European minds, with much uneasy debate about the need to reduce European dependence on Russian oil and gas and the scope of sanctions that should be imposed on Moscow. However, the immediate impact of the Ukrainian crisis appears to be limited for the main European economies and outweighed by continued signs of a moderate but increasingly widespread recovery in activity. Business surveys for March added to evidence that the eurozone's return to growth, which started in the second quarter of 2013, has been gaining some momentum. In addition, the European Commission's index of consumer and business sentiment for March rose for the 11th

month in a row. As for trade, recent figures from the European Central Bank (ECB) show that the eurozone has shifted decisively into a current account surplus, exporting more goods and services than it imports, thus boosting investor confidence in the eurozone.

There have also been advances on the institutional front in Europe, in our view. After two years of discussions, eurozone leaders finally signed up to “banking union,” which is designed to forestall the kind of banking crises witnessed in a number of countries in 2010–2011 by ensuring that governments are no longer the sole masters of the biggest banks registered in their countries. However imperfect, the union has been hailed as the most ambitious integration project since monetary union in 1999.

Improvement in the economic and financial complexion of peripheral European countries combined with a continued general investor hunger for yield has continued to push borrowing costs for these countries steadily downward. By the end of March, for example, the yield on 10-year Portuguese bonds had fallen to below 4% compared with a peak of 17.4% in May 2011, when Portugal had to be rescued by the International Monetary Fund (IMF) and the country’s European neighbors. The decline in Irish bond yields has been just as dramatic, while even Greece was able to organize a heavily oversubscribed medium-term bond issue in April.

But such an improvement in the eurozone’s finances has come at the price of huge compression in wages and domestic demand in crisis-stricken countries like Spain and Italy, which has pushed inflation down to well below the ECB’s target of at or a little below 2%. At the same time, Europe’s growing balance of payments surplus and slide toward deflation bear some resemblance to Japan’s experience of the last 20 years of stagflation.

We also think some perspective on recent improvements in the European economy is warranted. According to Eurostat, the seasonally adjusted unemployment rate for February was 11.9%, a solitary one basis point lower than a year before. Youth unemployment has been well over 20% in the majority of European countries, and over 50% in the case of Spain and Greece. Both the European Commission and ECB have forecast that eurozone GDP this year will grow by 1.2%—hardly enough to make much of a dent in the

unemployment rate or in the mountains of debt in some countries. Furthermore, if people and companies expect prices to fall (and prices have been falling in Spain, for example), they are likely to put off spending and thus choke the recovery.

In early April, Christine Lagarde, managing director of the IMF, voiced her concern about the situation and urged the ECB to consider “more monetary easing, including through unconventional measures.” Even though consumer price inflation fell further in March (to an annual rate of 0.5%), the ECB announced no new action at its governing council meeting in early April, keeping its main interest rate at 0.25%. The central bank did, however, say it was still looking at its options if Europe’s economic recovery does not go as planned and inflation does not pick up as the bank still expects it to do. A few days before the council meeting, a statement from Jens Weidmann, president of the Bundesbank, that QE in the eurozone “is not out of the question,” was considered highly significant, given German resistance to allowing the ECB to print money to buy government bonds. In our opinion, there is certainly no room for complacency on this front. Confidence in Europe’s prospects, while improving, appears to be brittle, and inflation expectations are still much lower in Europe than in the US, where growth has been much stronger. At the very least, base interest rates in the eurozone look set to remain very low for some considerable time to come. Rather than a reflection of any substantial improvement in fundamentals, the expectation of a prolonged period of low interest rates (and possibly QE) goes a long way toward explaining why peripheral eurozone bonds have continued to rally.

Most fundamentally, the jury remains out on how sustainable the current upturn in Europe will prove to be. Lending by eurozone banks to the private sector fell again in February, suggesting the recovery in the currency bloc could remain sluggish despite the recent signs of an economic turnaround. Further monetary stimulus might be expected to improve lending figures, at least. It might also go some way in offsetting geopolitical risks and the unease caused by the likely advance of populist parties at elections to the European parliament in May. But whether “unorthodox” monetary policies can do anything to boost long-term economic growth in a set of countries where demographics alone suggest a potential falling growth rate is open to question. The eurozone might turn to the UK for some immediate answers. Fiscal austerity and monetary stimulus through QE have

been the order of the day there since 2009. The UK has recently been reporting much stronger growth than in the eurozone (GDP growth in the UK reached 1.7% in 2013), and QE is seen as having been a major contributor to the turnaround in business and consumer confidence, as well as the recovery in orders and industrial output. However, as in the US, some argue that the huge outlays involved in QE (some £375 billion) would have been better spent on something more effective than buying government bonds. Critics also argue that QE is well past its "sell-by" date and is now feeding a dangerous asset price boom, most evident in housing prices, even as the UK has continued to post a large current account deficit.

**Important Legal Information**

*Given the rapid changes that can take place in markets and economic conditions, it's often difficult to provide up-to-date materials that address the most current situations. This material is intended to be of general interest only and should not be construed as individual investment advice or an investment recommendation. The views expressed are those of the noted investment manager and the comments, opinions and analysis are rendered as at publication date and may change without notice. The information provided in this material is not intended as a complete analysis of every material fact regarding any country, region or market.* **All investments involve risks, including possible loss of principal.**

Posted in Fixed Income Tagged Christopher Molumphy, Franklin Templeton Global Bond Funds, Franklin Templeton Global Economic Perspective, global fixed income investing, global impact of monetary policy, investing in global bonds, John Beck, Michael Hasenstab, michael materasso, perspective on US bond market, Roger Bayston

Important Legal Information
**FINRA's BrokerCheck**
You can check the background of your investment professional on FINRA's **BrokerCheck**.

Links can take you to third party sites/media, directly or through new browser windows. We urge you to review the privacy, security, terms of use, and other policies of each site you visit. You use any third-party site, software, and materials at your own risk. Franklin Templeton does not control, adopt, endorse or accept responsibility for content, tools, products, or services (including any software, links, advertising, opinions or comments) available on or through third party sites or software.

Franklin Templeton welcomes your feedback on this blog. To keep the conversation respectful and focused, please follow our current Commenting Guidelines. We review comments and reserve the right to block any comment or commenter, including those that we may deem inappropriate or offensive. We may block any comment or commenter whose posts include investment testimonials, advice, or recommendations, or advertisements for products or services, or other promotional content.

Questions or comments about your Franklin Templeton account or customer-service issues? Please contact us directly but never include account or personal financial information in your comments.

The comments, opinions and analyses are the personal views expressed by the investment manager and are intended to be for informational purposes and general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice. The information provided in this material is rendered as at publication date and may change without notice and it is not intended as a complete analysis of every material fact regarding any country, region, market or investment.

**All investments involve risk, including possible loss of principal.**

*Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN/342-5236 or visit franklintempleton.com. Please carefully read a prospectus before you invest or send money.*

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user.

**Franklin Templeton Distributors, Inc.**

© 2017. Franklin Templeton Investments. All rights reserved.

Using this site means you agree to our **Terms of Use**

**Click to view our Privacy Policy**