Global Economic Perspective: May

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Perspectives from the Franklin Templeton Fixed Income Group®

US Economy Appears to Shrug Off Poor First Quarter

We believe a substantial improvement in US growth is underway, despite first-quarter 2014 gross domestic product (GDP) growth coming in at an annual rate of -1.0%, well below market expectations. US Federal Reserve (Fed) Chair Janet Yellen struck a notably upbeat tone on prospects for the economy in testimony before Congress in early May, pointing out that the current rebound in consumer spending, employment and industrial production bodes well for growth in the second quarter. Adding to the generally upbeat mood was a recent surge in exports, which has helped reduce the US trade deficit. Yellen did signal her concerns about some recent slowing in the US housing market, while business-equipment spending has also remained somewhat soft, likely reflecting continued caution among US corporations. However, all in all, the US economy is widely expected to

accelerate during the second quarter, with questions remaining by how much would it expand and whether the momentum it seems to be gaining can be maintained through to the end of this year.

It may take some months before it becomes clear if the US economy is undeniably on a stronger and sustained growth path. Given this relative lack of visibility, it is not surprising the Fed has been generally hinting that base interest rates will remain low for some time to come—even more so given the strong jobs report for April (when hiring grew at its fastest pace in more than two years) was tarnished somewhat by statistics showing that the participation rate had fallen again.

Reassurances that base rates will remain low, possibly well into 2015, go a long way to explaining why US government bonds have continued to rally. Toward the end of last year, 10-year Treasury yields rose briefly to 3% as the Fed started to taper its monthly bond purchases. The Fed has been progressively tapering these purchases at every monetary policy meeting since then, thus gradually removing support from bonds. And yet by mid-May, 10-year Treasury yields had fallen to about 2.6%. For some, the continued resilience of Treasuries is puzzling given the US economy has picked up speed. Some of this rally may be ascribed to the buying of perceived safe-haven securities, driven by the ugly events in eastern Ukraine and lingering fears over China's slowdown. US Treasuries also have continued to offer better yields than their Japanese or German equivalents. But much of the decline in yields may be because even as the Fed winds down its bond purchases, market participants do not seem convinced that rates will rise very fast. Furthermore, bond prices may reflect not only uncertainty over the vigor of US growth in the short term, but perhaps also the realization that the slowdown in the rate of increase in the labor force could lead to softer long-term demand in the economy.

The uncertainty that has benefited US bond markets was conversely reflected in almost-stagnant US equity markets during March and April, but by mid-May the S&P 500 Index had climbed to a record high. For the moment, uncertainty over the US growth rate and low inflation, coupled with a near-deflationary Europe and lingering investor concerns about China, indicates to us likely continuation of low interest rates. Nonetheless, it continues to be our view that a solid US economic recovery could put upward pressure on interest rates. While we think bond markets have been distorted somewhat by massive

quantitative easing programs in Japan and the UK, as well as in the United States, we believe 10-year Treasury yields should be higher than the expected US growth rate this year (which consensus estimates believe may come in at over 3%). However, even as the Fed continues to taper its asset purchases, prospective monetary easing measures in Europe and Japan may mean a rise in yields would be gradual. Furthermore, it is our belief that any reasonable rise in long-term rates should not derail the US recovery, as any such rise in rates may be a response to a strong economy.

Preparing for a Potential Rising Rate Environment

The outlook for the global economic cycle is mostly positive, with the International Monetary Fund (IMF) forecasting global growth of 3.6% for 2014, compared to the 3% final outcome for 2013.[1] Although there has been an anticipated slowdown in emerging markets, the IMF sees growth in emerging market and developing countries picking up this year to 5.1% from 4.7% in 2013. Within the context of this broader theme of growth momentum, we believe Fed tapering, divergence in emerging markets, and China’s slowdown in growth are the drivers behind the recent period of elevated volatility.

In line with our unconstrained, global investment strategy, we believe individual countries are likely to continue differentiating themselves from other emerging markets through both robust fundamentals and the ability of policymakers to stay ahead of the curve regarding fiscal, monetary and financial policy. As 2013 confirmed, emerging markets can no longer be treated simply as one, uniform asset class—the performance difference between the best and worst emerging bond markets was over 40 percentage points, according to an analysis of constituent markets of JP Morgan Government global and emerging-market indexes. After temporary weak performance early this year, currency and bond markets in Asia and Latin America have stabilized in recent months, although the news has not been universally good. While we have seen a rebound in the South Korean won and Mexican peso, for instance, there have also been recent downgrades of the sovereign debt of Brazil, Venezuela and Argentina.

Despite negative headline news and general investor skepticism toward China, we do not see a hard landing for that country. Recently reported data did reveal issues with overinvestment in certain sectors, decreasing industrial production, and increases in non-

performing loans within the banking sector, but we believe these numbers do not reflect the full picture. In fact, the recent deceleration is a welcome and healthy dynamic, in our view. Although China's growth has declined in terms of quantity, we think recent reforms have improved its quality.

As long as China is able to correctly price inputs and move away from state-directed finance, we believe the country can continue to move up the value-added chain. In our view, the new administration of President Xi Jinping is poised to be one of the most transformational governments since that of Deng Xiaoping, who enabled China to embark upon a decade-long reform agenda and move toward a market-driven economy. President Xi has continued to increase competition by opening up China's economy and capital account, while one of the most positive factors of his reform agenda and an indicator of his strength has been his anti-corruption drive. Though there is potential volatility from such wide-ranging reforms, we believe China likely is likely to maintain a steady growth rate for the next one to two years. The underlying driver for this growth is a dramatic acceleration in wages, which should ultimately provide a core anchor for increased consumption. Additionally, we believe China's urbanization process shows an underlying need for investment despite expected moderation in investment levels over the next decade and slowing growth rates over the next couple of years. There is also some concern regarding the shadow banking system; however, we believe the problems are quite manageable given the size of the economy. The Bank for International Settlements has estimated China's shadow banking is a small percentage of GDP compared to a much larger percent in Europe. We believe the government has the financial resources to deal with the toxic part of the banking system given its positive net asset position.

Earlier this year, the perceived downturn in China and fears of a global liquidity crisis led to temporary weak performance of emerging-market assets amid a period of heightened volatility. More recently, however, the panic and uncertainty surrounding a potential global liquidity crisis has faded, allowing emerging-market countries with strong fundamentals to differentiate themselves from those with weaker fundamentals in terms of performance. Globally, we are not overly concerned about the effects of Fed tapering given the Bank of Japan's massive amount of quantitative easing. Certain countries, such as Turkey, which have large current account deficits, will likely face pressures, but other countries with

current account surpluses and low levels of debt are in good shape, in our view. Interestingly, policymakers in some emerging markets, particularly those in Asia, seem to be starting to feel the effects of Japanese quantitative easing and appear unsure about the appropriate policy response to manage the expected massive capital inflows.

European Outlook

In spite of persistent worries over European deflation and in spite of a disappointing first quarter GDP report (when the eurozone economy grew at a quarter-over-quarter rate of 0.2%), we've seen signs of a broadening of the economic recovery in at least some parts of the region, with domestic consumer spending beginning to pick up on the heels of a noticeable improvement in industrial activity. Two of the continent's biggest economies, the UK and Germany, seem to be doing well. The Organisation for Economic Co-operation and Development recently raised its 2014 GDP growth forecast for the UK to an impressive 3.2%,[2] with improvements in manufacturing showing that Britain's revival may not be limited to an unsustainable housing binge, while Germany's economic ministry has upgraded its growth forecast for the country to 1.8% this year. Reform-shy France has been noticeably trailing in the growth stakes, but the recent appointment of a thoroughly market-friendly Manual Valls as prime minister, together with the unveiling of major government spending cuts and lower social charges for businesses, suggests that the French economy could partake in the upswing. Italy—which has also equipped itself with a youthful and reformed-minded prime minister, Matteo Renzi—is also emerging from recession, while the Spanish economy grew at its fastest quarterly pace in six years during the first quarter.

We believe the results of improved data—together with improved state finances and what appears to be the final capitulation of speculators counting on a breakup of the European monetary union—meant that spreads for peripheral European government bonds over German Bunds have continued to fall. But the drop in inflation and inflation expectations has also played a role, in our view, with bond investors generally betting on further action by the European Central Bank (ECB) in the face of possible eurozone deflation to push down bond yields.

In the case of Spain, by mid-May, 10-year government bond yields had fallen to their lowest level ever, well below where they stood even at the start of monetary union in 1999. Italian bonds told a similar story, with the country's 10-year issues offering yields of below 3% in mid-May. Another milestone was reached when Portugal announced on May 4 that it would make an exit from its three-year bailout without the safety net of a precautionary credit line. Portugal's announcement followed a successful €3 billion five-year bond sale by Greece a month earlier in that country's first foray into the debt markets since its first bailout over four years ago.

However, we believe risk factors persist that the recent fall in bond yields may not be taking fully into account. Already high public debt-to-GDP ratios in most of the crisis-ridden countries have continued to rise or are falling only very slowly. According to Eurostat, the ratio for Ireland was almost 124% at the end of 2013, 133% for Italy, 129% for Portugal, and 175% for Greece (up from 157% the previous year). To public debt must be added private debt, which is particularly high in Ireland. Since the servicing of their public debt remains high, all these countries will likely have to maintain high primary surpluses, if only to comply with the 3% fiscal deficit threshold imposed by eurozone rules.

Yet, in the context of drawn-out structural consolidation and very low inflation, growth is likely to remain relatively weak, making it difficult to bring down debt ratios even if primary surpluses are achieved. While the nominal yield on Greek 10-year bonds had dropped to around 6.2% in mid-May, having gone as high as around 45% in May 2012, this level was still painfully high for a country that the IMF forecasts will grow by only 0.6% this year[1] and that is experiencing deflation (prices fell 1% in 2013, according to Eurostat). And when the drop in prices is taken into account, real (as opposed to nominal) yields throughout southern Europe are actually higher than before the sovereign debt crisis of 2010.

All in all, one can say low nominal yields and inflation in Greece, Italy and elsewhere reflect economies that are trying to address their structural problems through painful austerity measures that may have steadied investors' nerves, but have also resulted in high unemployment and depressed demand. The poor figure for GDP growth in the first quarter illustrates just how tentative recovery is in much of the eurozone. Output gaps (meaning the difference between actual and potential growth) remain very wide, while lower-than-

anticipated inflation means the burden of repayments on households, corporations and governments alike has been rising in real terms. And in reality, investors are still demanding a hefty credit premium to invest in peripheral countries.

Some short-term relief could come if the ECB loosens monetary policy further to combat deflation and weaken the euro, as its president, Mario Draghi, hinted in early May. The ECB may also do something to boost the securitization market and lending to small- and medium-sized enterprises. Yet, all things considered, although the situation throughout peripheral Europe is markedly better, in our view, prospects continue to be fragile and extremely sensitive to any unforeseen events. But the ECB's forward guidance seems to have reassured markets that short-term rates will remain very low for an extended period, which we believe should be supportive of the European bond market.

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2. Source: OECD, May 2014 Economic Outlook database.

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