Global Economic Perspective: July

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Perspectives from the Franklin Templeton Fixed Income Group®

Federal Reserve Faces Strong US Jobs Gains and Rising Inflation

The US recovery has continued to gather pace. Purchasing manager index (PMI) reports showed that the US manufacturing sector expanded further in June, driven by strong growth in output and new orders. Along with buoyant business surveys, manufacturing and durable goods reports have been robust. The feeling that the economy has dusted off the dramatic first-quarter 2014 slowdown (when gross domestic product declined at an annual rate of 2.9%) was reinforced by the first reading for June nonfarm payrolls, which showed that the US economy added a better-than-expected 288,000 jobs in June. Additionally, the excellent jobs figures for April and May were revised sharply higher. Meanwhile, new and existing home sales soared in May.

Other US economic data, however, have been somewhat mixed. Auto sales have boomed, but consumer spending as a whole was lackluster in May. Some observers explain the sluggish consumer spending numbers by pointing to anomalous, one-off health-spending figures, while noting growth in income and household wealth bodes well for the months ahead. The US Department of Commerce did indeed report a fifth straight monthly gain in personal incomes for May. But recent rises in consumer price inflation (to an annual pace of 2.1% in May) due to higher food and energy prices have eroded real disposable incomes. Although household wealth in the upper-income segments of the population has risen as a result of rising US home prices and stock markets, some research shows that wealth among median US households has actually fallen in an increasingly unequal society. The overhang of household debt in addition to the relatively slow pace of growth in disposable income helps explain why figures from the vital consumer sector have been mixed.

The economy’s tumble in the first quarter will likely have an impact on growth levels over 2014 as a whole. While the second quarter is seen as likely to have been strong for the US economy, and while hopes are high for the rest of the year, the first-quarter disappointment has forced the Federal Reserve (Fed) and other forecasters to downgrade their predictions for US growth in the 2014 calendar year, perhaps helping to explain why US government bond yields currently remain low. However, it is our view that consumer expenditure and capital investment should eventually start to benefit from the rising confidence shown in household and business surveys as well as continued strong jobs growth. The economy is also being helped by a Fed that has yet to give any clear sign it is turning more hawkish.

But can the Fed be counted upon to remain so relaxed about interest rates? The strong nonfarm payroll figures of the past three months brought the official unemployment rate down to 6.1% in June—well below the 6.5% level the Fed was trumpeting as the threshold for rate tightening earlier this year. The Fed can point to less evident improvements in the labor market participation rate, which is still lower than a year ago and much lower than before the 2007–2009 recession, as a reason for caution. But if the trend of recent months continues, we could see capacity constraints and wage inflation linked to continued declines in unemployment even though the participation rate does not improve much.

The potential for rising inflation is another dilemma the Fed faces. In a statement at the end of a Federal Open Market Committee (FOMC) meeting in June, the Fed kept its inflation forecasts almost unchanged, seeing both headline core personal consumption expenditure (PCE), an inflation measure that strips out volatile food and energy prices, of 1.5%–1.7% this year and predicting below-target inflation all the way until the end of 2016. But the core PCE index had already risen to an annual 1.5% rate by May 2014, suggesting that the Fed does not believe there will be much of a further rise in the pace of inflation growth over the next two and a half years beyond what has occurred. Our view, however, is that given the quickening pace of growth, combined with continued improvements in employment, the expectation that inflation will stay at its current levels may turn out to be unjustified. A rise in PCE inflation closer to 2% generally would be considered beneficial to the economy as it would likely boost spending, but if the economic picture continues to brighten, the Fed may be hard pressed to keep base rates at or close to zero for the next 12 months.

If the Fed is forced to act, there is a potential danger that some market participants will be caught out. In broad terms, bonds, like a range of other financial assets, have been boosted by continued, high levels of liquidity being pumped into the markets by large central banks in the western world, including the Fed, the Bank of England and the Bank of Japan. So far, foreign buying has trumped improving US data in determining the direction of yields, including US Treasury yields. But the current low level of US Treasury yields and interest rate futures also suggests, at least in part, that bond traders generally do not consider inflation to be a concern, that the FOMC is being too optimistic about the economic pick-up over the rest of this year and next, and that, consequently, interest rates are likely to remain low well into this decade. In early July, there was a noticeable disconnect between the median forecast of Fed officials for interest rates by end-2015 and the markets' forecast, as expressed in the federal funds futures rate. But if unemployment continues to decline and inflation to pick up in the coming months, the danger for bond market participants is that their predictions for interest rates may be too low and will have to be adjusted.

Asian Markets Seen as Stabilizing

Figures from China's National Bureau of Statistics and other observers showed that China's manufacturing PMI increased in June. Other official data, such as industrial output and retail sales figures, indicate that the Chinese economy is stabilizing as recent "mini stimulus" policies have kicked in to help ensure that economic growth reaches the government's target of about 7.5% this year. Recent measures to maintain growth have included cuts in the required reserve ratio for smaller banks as well as central bank loans to commercial lenders. Interest rates have also come down as the rate paid on money market funds has decreased from more than 6% to less than 5%.[1] Other stimulus measures have targeted small businesses, agriculture and infrastructure projects such as railway and urban redevelopment.

If necessary, the People's Bank of China could further reduce reserve requirements or even order banks to lend directly to businesses. Nevertheless, we think China is unlikely to repeat its massive 2009–2010 effort, when the authorities unveiled a 4 trillion yuan ($635 billion) stimulus program to combat the impact of the global financial crisis. The Chinese are conscious that the vast spending unleashed at that time is at the root of some of the country's current problems. They are also aware that the proposed easing of rules regarding banks' loan-to-deposit ratios could hinder the government's goal of reducing the economy's reliance on debt financing. We expect China to continue to adopt a measured approach to lifting the economy, focusing on structural reforms to improve the quality and sustainability of growth and to boost domestic consumption over the medium and long term. The combination of growing labor shortages in some sectors and productive investments in areas such as environmental technologies, transport and urban infrastructure should further support growth. We are also of the view that the government has ample capacity to recapitalize any bank, should the need arise, thus alleviating concerns regarding the banking sector.

The apparent stabilization in the Chinese economy amid the US recovery is welcome news for other Asian economies. While individual markets need to be assessed on their intrinsic merits and some continue to face fundamental challenges, the dire predictions of some observers regarding emerging markets and a possible shortage of global liquidity have not

come to pass thus far in 2014. Instead, continued strong global liquidity and yields we regard as attractive indicate that most investors have been covering short positions and supporting Asian bonds and currencies.

Further signs of policy dynamism in large economies may continue to positively impact other Asian markets. For instance, in India, the government of newly elected Prime Minister Narendra Modi announced plans to reform contentious land acquisition laws that have brought important projects to a halt. Reform is also in the air in Japan. After pushing through aggressive fiscal and monetary policy measures, the government of Prime Minister Shinzo Abe provided precise updates on its structural reform plan in June, emphasizing the “third arrow” of Japan’s policy mix designed to revive a stagnant economy. Abe announced plans to diversify the investments of the Government Pension Investment Fund, the largest pension fund in the world; he intends to invest its premiums, more than half of which are currently in low-return Japanese government bonds.

European Outlook

Bank of England Governor Mark Carney briefly ruffled feathers in mid-June by hinting that benchmark interest rates in the UK could potentially rise faster than the markets were expecting, setting the Bank of England up as the first major central bank to potentially tighten policy in the months ahead. However, the Bank of England has already taken some initial steps to improve the sustainability of the UK recovery and head off a housing bubble by imposing a limit on mortgage borrowing—thereby perhaps delaying the moment when base rates need to rise. Carney took a more dovish tone when he spoke again toward the end of June. This time, Carney said the UK economy was likely to grow more strongly in the second half of the year than the Bank of England had been expecting, yet subdued wage growth suggested there was still some spare capacity to be used up before a rise in benchmark rates was needed. Besides, inflation has remained well below the central bank’s 2% target rate and inflation expectations have been subdued.

Carney’s vacillations on interest rates have led to confusion among many investors, for which he has been duly criticized. However, his comments and the parsing of what they mean, at the very least, illustrate just how difficult it is for central bankers to justify

expansionary monetary policies during a period of rising asset prices as well as strong improvements in the economy and employment.

But the difficulties of formulating monetary policy have not stopped the Bank of England's governor from talking down the scope of monetary tightening when it does come, saying that interest rates were unlikely to recover to their pre-crisis levels because "things have changed," referring to the high level of household debt and new, more exacting regulatory requirements on banks, under which they will have to charge a higher margin above the central bank's benchmark rate than previously when they make loans to households and businesses. It is likely the queasiness of large economies on the European continent is a further factor in staying the Bank of England's hand. But the fact remains that the UK economy grew at a strong annual rate of 3.0% in the first quarter, while UK employment grew by 345,000 between February and April, according to the Office for National Statistics, and the workforce participation rate is close to a record high. So whatever slack remains in the UK economy appears to be declining rapidly.

In contrast to the liveliness of the debate on the direction of monetary policy in the UK, rate hikes in the eurozone look a lot further off. Instead, the European Central Bank (ECB) cut base rates in early June and hinted it may introduce some form of quantitative easing (QE) should conditions, such as a sustained drop in inflation to unacceptably low levels, require. The ECB remains adamant that inflation will improve in the months ahead, obviating the need for QE. Indeed, the drop in price inflation may be stabilizing, holding out hopes for some improvement as time goes on, much as would seem to be happening in the US. However, the annual headline rate of inflation for the eurozone—at 0.5% in June—remains stuck at its lowest level in more than four years. And in another area of likely ECB concern, Eurostat figures showed bank lending to households and businesses continuing to decline in May.

The ECB may hope that better efforts by Europe's politicians to kickstart growth will remove the need for QE. Center-left politicians, including Italian Prime Minister Matteo Renzi (perhaps with backing from French President François Hollande), would like more flexibility in the eurozone stability pact to accelerate the path to growth. But, for the moment at least, there is little evidence that European growth is about to break radically higher from the weak levels of late. Indeed, composite PMI readings for June even showed

a slight slowing in the rate of expansion in European manufacturing and services. The PMI reading for France underlined how relatively feeble the eurozone's second-largest economy has become, to some extent obscuring continued signs of healthy progress in Spain.

Additionally, while Spanish unemployment slid for the 11th consecutive month in June according to local labor ministry figures, for the eurozone as a whole it remained stuck at 11.6% in May, according to Eurostat, serving to underline that whatever recovery there is in the eurozone bloc, it is far from strong enough to spur solid job creation in all countries. The combination of anemic growth and a lack of inflation—plus the possibility that we may see some form of QE if activity remains persistently sluggish and inflation does not pick up—helps explain why 10-year government bond yields for countries at the heart of the eurozone sovereign debt crisis like Spain and Ireland dipped below US Treasury equivalents by the end of June, while Italian 10-year yields were only slightly higher. In addition, with the Fed curtailing its monthly asset purchases since January, the US is switching to less expansionary monetary policy just as the ECB seeks ways to loosen policy further.

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1. Source: China Foreign Exchange Trade System & Nation Interbank Funding Center.

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