Global Economic Perspective: August

August 15, 2014

Perspectives from the Franklin Templeton Fixed Income Group®

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US Growth Looks Sustainable For Now

The US economy seemed to move into a higher gear during the second quarter, when gross domestic product (GDP) growth reached an estimated annual rate of 4%, supported by personal consumption and inventory build-up. Its first-quarter downturn also was not quite as severe as previously thought, falling by an annual rate of 2.1% instead of the 2.9% initially reported by the Bureau of Economic Analysis.

The upbeat tone among US households was underlined by a surge in The Conference Board's reading for consumer confidence in July. Similarly, a noticeable improvement in job creation, with nonfarm payrolls adding an average of 245,000 new jobs per month in the three months ended July 31, shows the growing confidence of employers. An uptick in job seekers suggested would-be employees also have become more hopeful—and well they might, since long-term unemployment fell by 1.1 million individuals in the 12 months ended July, according to the Bureau of Labor Statistics. Purchasing manager index (PMI) readings have also been providing good news. The Institute for Supply Management's survey of manufacturing rose to a three-year high in July, while its survey of the services industry rose to an eight-year high in the same month. Second-quarter corporate earnings (with some exceptions) generally have been encouraging, with earnings for S&P 500 companies finally showing signs of being boosted by revenue growth rather than cost-cutting. Finally, the effect on GDP data due to the fiscal drag of restrained government spending has been fading.

But it is probably too early to surmise that the US economy has reached "escape velocity." There remain nagging doubts that revolve around the fickleness of inventory numbers, rising geopolitical concerns, weak (albeit improving) wage growth and some conflicting signs in the housing market. The US Federal Reserve (Fed) noted on July 30 that "a range of labor market indicators suggests that there remains significant underutilization of labor resources." A modest deceleration in job growth in July and an equally modest rise in the unemployment rate (together with mild inflation) have helped bolster the case for keeping interest rates low. There are also some more fundamental concerns, in our view. Growth in US productivity, for example, has been noticeably weak this decade compared with the past and could signal increased pressure from wage inflation if employment figures continue to improve. The fall in the growth of the labor market plus weak productivity gains has led entities like the Congressional Budget Office and the Fed to trim their forecasts of potential growth over the medium term.

Global geopolitical concerns, including the situation in Ukraine, have helped keep a lid on benchmark 10-year Treasury yields, as have continued Fed reassurances that it intends to keep interest rates low. Historically low yields on benchmark sovereign bonds in Germany and elsewhere in Europe are making Treasuries look comparatively attractive, in our view.

Nonetheless—and in spite of the Fed's concerns about residual slackness in the US jobs market—the second quarter's 4% GDP reading, plus indicators that growth remains buoyant as we move further into the third quarter, has increasingly focused attention on an inevitable turn in the interest rate cycle. Volatility has moved up a notch in areas that include the S&P 500 Index, while some disenchantment with high-yield debt has emerged, prompted in part by comments from Fed Chair Janet Yellen that valuations for high-yield bonds "appear stretched." At the same time, we believe credit markets remain broadly supported by low inflation, underlying improvement in the US economy and default rates that remain well below the long-term historical average.

Global Markets Appear to Take Geopolitics in Stride

The weak first-quarter economic performance of the US and some other developed and emerging countries has led the International Monetary Fund (IMF) to slightly reduce its global growth forecast for 2014 from 3.7% to 3.4%.[1] However, the IMF has maintained its 4% global growth projection for 2015 as leading indicators suggest that growth has been picking up in many major economies. Indeed, as noted above, US growth for the second quarter recovered sharply.

In other developments, the recent increase in geopolitical tensions—including the souring of Western relations with Russia, China-Japan tensions, the breakdown of order in Libya and Iraq, and the continuing civil war in Syria—have had a remarkably muted impact on global financial markets so far. There has been no rise in gold prices, and oil prices had fallen to eight-year lows by the end of July (although Brent crude oil prices lurched upward in August as the situation in northern Iraq escalated).

As a result of investors' generally measured response to recent events, in July emerging markets continued to make up for some of the weaker performance seen during the early months of this year. Credit default spreads continued to decline, and while the US dollar broadly strengthened in July, some individual currencies such as the Malaysian ringgit and the Indonesian rupiah gained ground. Even Argentina's sovereign bond default in late July did not stop emerging-market bonds overall from outperforming other fixed income asset classes during the month.[2] The lack of contagion in the wake of the Argentine default may be explained to some extent by the fact that the issues underlying the default were very

specific to Argentina, in addition to being well known. As such, there appears to be an expectation that they will have no major impact on prospects for the global economy, which instead continues to be dominated by the pick-up in growth in the US and stabilization in China. The continued abundance of global liquidity has also played a role. As the European Central Bank (ECB) and Bank of Japan continue to conduct monetary easing, the yield offered by emerging-market bonds remains relatively attractive to many investors.

However, rising speculation about the direction of Fed monetary policy, plus further strengthening of the US dollar, could still pose challenges to some emerging-market countries. Many observers recall the "taper tantrum" of late 2013, when talk that the Fed was preparing to pare its monthly bond purchases, resulted in turmoil in countries whose capacity to finance their debts was compromised by the sudden drying up of short-term investment inflows.

Yet all emerging markets are clearly not identical. Individual country debt profiles in the emerging-market space are very different, with some countries appearing to us to be better prepared for a possible rise in volatility than others. In several countries, recent drops in inflation indicate higher real interest rates, current account balances have improved, and central banks have used currency rallies to rebuild a buffer of foreign exchange reserves. More fundamentally, economic adjustments continue apace in many places: In recent weeks, Mexico advanced legislation that would open up its energy sector; Indonesia, where a new president has been elected, is moving to reduce expensive fuel subsidies; and a new administration in India is aiming to curb bureaucracy. In China, important financial reforms, which range from interest-rate deregulation to less reliance on banks and more on capital markets, should make the financial system more robust over time.

European Outlook

Economic data for the eurozone continue to be quite mixed. Business surveys have suggested that the services sector in the eurozone expanded at the fastest pace in three years in July, with PMI readings well above the 50 mark that divides expansion from

contraction. Additionally, eurozone retail sales rose at the fastest rate in seven years in June, and twice as fast as expected, according to Eurostat data released in early August.

But PMI readings for the manufacturing sector have been decidedly underwhelming. PMI readings for manufacturing compiled by Markit did signal buoyant activity in a number of countries such as Ireland, Spain and the Netherlands, but the figure for France, the eurozone's second-largest economy (for now), was well below the 50 level, with a marked deterioration in new orders. The PMI reading for services in France was also noticeably weaker than in other large economies. More worrying still is Italy's long decline. Hopes that its moribund economy might start to see some feeble signs of light were dashed when the national statistics agency, ISTAT, reported that the country's GDP declined by 0.2% in the second quarter. Given Italy's negative growth in the first quarter, the country is therefore officially back in recession.

Overall, the business survey data for eurozone manufacturing were seen as relatively disappointing, possibly reflecting growing concerns about the escalation of the crisis in Ukraine in July, which saw the West impose a range of new sanctions on Russia. Sentiment in central and eastern European countries with the closest economic ties to Russia has been hit by the standoff between Russia and the Western powers, but some forecasters (such as the Munich-based Ifo Institut) have also been downgrading their short-term forecasts for German growth in view of the situation.

Another persistent worry for the eurozone is the lack of inflation. Consumer price inflation fell yet again in July (to 0.4%), according to Eurostat. Low inflation will likely put further pressure on the ECB to introduce still more unconventional measures to stimulate growth, possibly even outright quantitative easing (QE). However, further ECB action in the short term—so soon after its June cut in base rates and with its "targeted" long-term refinancing operations (LTRO) program set to launch in September—is not a done deal. The weakness in inflation in July stemmed from declines in energy and food prices, while the less-volatile core measure, which excludes these goods, stayed at 0.8%. This is still an uncomfortably low level, but the fact that the core figure was unchanged from June and slightly higher than in May suggests to optimists that disinflation may have plateaued. Indeed, the ECB can point to easing credit conditions as a hopeful sign that demand could improve. The ECB's quarterly lending survey, which reported that banks had relaxed credit standards for

all types of loans in the three months to June, seemed to vindicate ECB policies so far. The upcoming launch of the new targeted LTRO might be expected to spur lending to households and small businesses even more.

Just as importantly, even without US-style QE that involves regular purchases of fixed income assets, nominal government bond yields have fallen to historically low levels in the eurozone. In these circumstances, it is hard to imagine how QE could have more than a marginal effect on yields that are already so low, especially if—as optimists continue to believe—deflation fears fade this year and the next and the European economy accelerates somewhat. The ECB will likely come under pressure to be seen as doing something more to alleviate the deflationary threat hanging over the eurozone, especially as the ECB’s balance sheet has actually been contracting since 2012 as eurozone banks have repaid early the loans they received from the central bank as part of an earlier LTRO program. But the ECB will probably also be wary of moves by France and Italy, which, under the auspices of newly appointed center-left prime ministers, are pushing for some alleviation of the strict fiscal discipline imposed on them by eurozone pacts and for more prudent northern Europeans (especially Germany) to agree to more expansionary fiscal measures.

In the meantime, the European sovereign bond market continues to steam ahead. Heightened geopolitical concerns (including the fresh sanctions on Russia), a cloudy economic outlook, low interest rates and the prospect of further deflation-fighting action by the ECB drove sovereign yields in many European markets to record lows by early August.

With the pick-up in the US economy leading to increased talk of policy normalization there, but monetary easing still the order of the day in the eurozone, we believe there could be some yield divergence between US Treasuries on the one hand and European (and Japanese) benchmark bonds on the other. Eurozone bonds could also look attractive to investors relative to UK Gilts, as speculation has risen about the direction of monetary policy in the UK after it reported annualized GDP growth of 3.1% in the second quarter (the same as in the first). At the same time, the impressive rally in some peripheral eurozone bonds could well peter out, especially if Italy fails to up its game in terms of growth and

institutional reform. Meanwhile, a crisis that engulfed Portugal's largest bank and led to a state bail-out could have repercussions on Portuguese growth and indicates that there are likely still issues lurking in the country's banking sector.

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2. As measured by the JP Morgan Emerging-Market Bond Index (EMBIGD) versus Citi World Government Bond Index.

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