FIXED INCOME

Global Economic Perspective: September

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Perspectives From the Franklin Templeton Fixed Income Group®

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US Economic Expansion Poses Quandary for Treasuries

Having expanded at an annualized rate of 4.2% in the second quarter, the US economy has continued to show solid growth as it moves through the third quarter. Retail spending data were slightly weak in July and, according to initial estimates by the Bureau of Labor Statistics (BLS), job growth was lower than consensus expectations in August, but the US Federal Reserve's (Fed's) "Beige Book" survey of activity from Fed districts around the country signaled that economic activity largely picked up during the summer after the soft

patch at the beginning of this year. The Beige Book survey, based on data collected before August 22, asserted that "none of the districts pointed to a distinct shift in the overall pace of growth," suggesting that expansion was solid but not spectacular. Other measures of economic health released in recent weeks have been more resolutely positive. Record exports helped push the US trade deficit to its lowest level in six months in July, for example. And purchasing managers index (PMI) reports for August showed that activity in the US manufacturing and services sectors was growing much faster than in Europe, Japan or even China, while continued strong monthly job gains (which ran at over 200,000 per month for the six months through July) suggest that consumer spending should pick up again.

While the Fed has acknowledged the improvement in labor market conditions and the fading of downside risks to inflation, Fed Chair Janet Yellen presented a relatively balanced view regarding the direction of monetary policy during her address to the Jackson Hole gathering of central bankers in late August. Yellen said that the Fed was "not on a preset path" but pointed out that while employment was improving, wages were creeping up at a glacial pace, which she took as an indication of lingering slack in the economy. In general, judging by financial markets' relatively mild reaction, Yellen was deemed to have done nothing to change expectations that the Fed will start raising rates around the middle of next year.

Expectations that the Fed will not move to normalize monetary policy until well into 2015 and that the European Central Bank (ECB) will be forced to be even more accommodative before then have dragged yields on benchmark long-term German Bunds below those for comparable US Treasuries—helping explain why Treasuries have continued to deliver comparatively robust returns so far this year. Ultra-loose monetary policy in Europe and Japan has led to a strengthening of the US dollar, thus boosting returns for foreign investors in Treasuries. The continued rally in long bonds is also in part due to geopolitical concerns about the Middle East and Ukraine. Thus, the global reach for perceived safety and for yield has been driving demand for long-dated Treasuries and seemingly trumping fundamentals. There also appears to be a widespread expectation that even after the Fed embarks on monetary policy normalization, rate increases are likely to be modest.

Treasury yields, however, have fallen below even where a dovish Fed has been saying rates will be over the next few years. The Federal Open Market Committee's median projected level for the federal funds rate at the end of 2015 and 2016 has increased consistently this year, which indicates that the Fed—but not the market—sees a continuation of progressive improvement in the US economy. Thus, there is the suspicion in some quarters that the prolonged Treasury rally will quickly wither if recent job gains stick and wages rise, thus forcing the Fed to tighten policy faster than expected. Already, the short-term unemployment rate, which tends to be a leading indicator for wages, has been falling, thus likely increasing inflationary pressures.

The yield curve has flattened in recent months, as short- and medium-dated US paper has not shared in the long-term Treasury rally. Reflecting the prospect of rate increases beginning in 2015, the two-year Treasury note yield was sitting close to a 27-month peak at the beginning of September—an indication of growing concern over the timing for the first Fed interest-rate hike. A flattening yield curve is often taken as indicating that fixed income investors foresee an environment of slowing economic growth. But given the distortions caused by aggressive Fed policy, one should probably not read too much into this, in our view. While some parties fret about a potential slowdown in US growth because of the country's aging demographic structure and growing public debt, the United States continues to benefit from several other factors. Its dependency on imported energy has diminished, turning oil from one of the most volatile commodities into one of the least. Together with the large expansion of renewables, shale extraction is creating more domestic supply, helping keep energy costs low for US businesses and consumers. In addition, American corporations have remained persistently efficient in recent years. Nonfarm labor productivity, or output per hour worked, rose by 1.1% in the second quarter of 2014 over the same period in 2013, according to a BLS release in early September. This figure is in line with meager productivity growth of around 1% recorded in 2012 and 2013. But hidden by these stark figures, which include the public sector, is another story: Earnings and growth in US corporate profit margins over the past five years have been growing much faster than operating costs, which we believe speaks of a persistently efficient private sector.

Geopolitics Dominate Global Picture

At the same time, it is unclear whether currently low volatility in energy prices will be maintained given the escalation of geopolitical tensions in the Middle East, particularly in Syria, Libya and Iraq. Adding to concerns about commodities is the continuing crisis in Ukraine, with Western powers responding to Russian intervention in eastern Ukraine by tightening sanctions on Russia and reducing Moscow's access to international capital markets. At the time of this writing, a satisfactory end to the crisis still seems some way off, making the outlook for the ruble as well as other Russian assets uncertain, despite the hefty declines they have already registered. Russia has a low level of public debt and large foreign-exchange reserves, meaning it could probably survive without access to bond markets for some time. Starved of fresh capital, as foreigners are restricted from investing in Russian assets, and with inflation rising fast because of the ruble decline and import restrictions, the Russian economy faces a tough winter. The country's central bank has been forced to raise base rates on more than one occasion this year, hurting business and corporate confidence. Meanwhile, Ukraine continues to perform under the aegis of its International Monetary Fund-supported program, but the real economy has taken a substantial hit. At the same time, the European Union has so far shown a relatively united front despite varying degrees of exposure to the Russian economy and dependencies on Russian oil and gas.

Elsewhere, the economic picture in various major emerging economies is somewhat patchy, in our view. For instance, data showed that activity in the Chinese services sector expanded strongly in August. China posted a healthy trade surplus in July, though official PMI numbers indicated that the manufacturing sector slowed in the same month. Brazil entered recession in the year's first half, and forecasts for growth in 2014 as a whole as well as for 2015 have been revised downward. Still, Brazil's upcoming general election, with the emergence of former Environment Minister Marina Silva as a feasible candidate, could prove to be a market catalyst. Depending on the result in October, Brazil might benefit from a post-election boost of the sort that India and Indonesia have recently experienced. Data showing that the Indian economy expanded at an unexpectedly high annualized rate of 5.7% in the quarter ended June 30—its best figures since early 2012—have added to optimism among global investors that Narendra Modi, elected prime minister in mid-May, may implement long-awaited economic reforms. In Indonesia, confirmation that Joko Widodo, the governor of Jakarta, won the July presidential election

continued to boost financial market performance in early September. With hopes that Widodo will tackle distortions produced by the country's generous fuel subsidies, the Indonesian rupiah made up some lost ground against the US dollar in August and Indonesian bond yields have dropped.

European Outlook

Compared to even the modest market expectations at the beginning of this year, it seems safe to say that the eurozone economy has disappointed. Eurostat reported that there was zero growth in the single-currency area in the second quarter, in spite of a few points of light in the 18-member currency bloc, especially in Ireland and Spain. Perhaps most telling was the 0.2% decline in Germany's seasonally-adjusted GDP during the quarter. The disappointing performance of an economy once considered the one major bastion of growth in the eurozone echoed that of the region's second- and third-largest economies, France and Italy, which respectively stagnated and fell back into recession during the second quarter. More up-to-date statistics have been no more reassuring, with business surveys showing a slowdown in eurozone manufacturing growth in August as new orders dwindled and factories suffered amid rising tensions in Ukraine. Manufacturing activity in France fell at the fastest pace in 15 months. Not surprisingly, the ECB has revised down its GDP growth forecast for the eurozone to a measly 0.9% for this year and to 1.6% for 2015.

Ominously, there seems little prospect of activity picking up decisively if inflation continues to decline. Consumer price inflation dropped to 0.3% in August, according to Eurostat, compared to 1.3% a year earlier. Falling inflation, combined with zero growth, suggest that the eurozone may be flirting with stagflation. More worryingly still is some evidence that expectations for low inflation are becoming entrenched at levels far below the ECB's target of just below 2%.

Not surprisingly then, the possibility of further action from the ECB has remained firmly at the center of market attention. At a meeting of central bankers at Jackson Hole in late August, ECB President Mario Draghi signaled his willingness to do more to prevent Europe from being sucked into a deflationary trap of the kind Japan has been in for more than two decades. His words were seen as increasing the chances that the ECB will launch at some stage a new round of unorthodox measures aimed at boosting growth. On September 4,

the ECB took some observers by surprise by actually taking the orthodox route of cutting rates even further, announcing a 10 basis-point cut in its main interest rate, taking it to a new all-time low of 0.05%. Somewhat less conventionally, the central bank said it would charge lenders more for parking deposits at the central bank and unveiled plans to buy asset-backed securities and covered bonds in October. September also saw the official launch of the ECB's €400 billion targeted long-term refinancing operations (TLTRO), which will see the ECB provide cheap loans to banks on the condition they are used specifically for lending to companies and households.

But the ECB once again stopped short of quantitative easing (QE, which entails the outright purchase of financial assets, including sovereign bonds and private-sector debts), although many parties persist in believing the ECB will eventually have to step in to buy sovereign bonds. European sovereign bond yields have fallen to historically low levels already, below comparable US Treasury levels, so QE may have only a marginal effect in terms of government borrowing costs. But QE could provide reassurance to firms and investors that the ECB is absolutely committed to squashing the risks associated with below-target inflation. And QE—or any other unorthodox action taken by the ECB—might have a far greater effect on the exchange rate than on bond yields, pushing the euro down and effectively acting as a devaluation of the single currency. A weaker euro would likely boost the export sector by pushing up import prices, and it could shift the eurozone away from the deflation danger zone. Draghi has already managed to talk down the euro, with the single currency steadily losing ground against UK sterling and the US dollar since the June TLTRO announcement. Its decline accelerated further after the September 4 interest-rate cut.

But QE remains a thorny issue in the eurozone, which helps explain why Mario Draghi used his Jackson Hole speech in late August to call on governments to allow fiscal policy to play a greater role in pulling the currency bloc out of its current slump. Some have interpreted his call for a "policy mix that combines monetary, fiscal and structural measures at the union and at the national level" as a call for the eurozone's leaders to recognize the merits of some coordinated fiscal expansion and to show more flexibility on austerity policies.

Pressure for a new fiscal compact is certainly growing, and some governments are pushing for a postponement of fixed deficit-reduction targets in exchange for evidence that they are committed to structural reform. After a painful birth, a new, more fiscally orthodox government seems finally to have appeared in France, inspiring some confidence that labor reforms might actually make some headway in an economy that has performed notably beneath its potential for a number of years. In Italy, reformist Prime Minister Matteo Renzi's progress so far in reforming the country's political system and labor market might give him some leeway in negotiations on taxes and spending with the European authorities. Together, the French and Italians could argue that a continuation of fiscal consolidation plus structural reforms would continue to weigh on eurozone growth.

Some fiscal expansion, together with further monetary measures could, it is hoped, boost nominal growth in the eurozone. Of course, if that turns out to be the case, then investors could require significantly higher medium-term yields to buy government bonds since economic recovery would also raise the odds of a medium-term tightening of monetary policy. But any such notion is still a long way off, in our view.

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