Global Economic Perspective: October

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Perspectives From the Franklin Templeton Fixed Income Group®

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Debate Over Potential US Rate Increases Gathers Steam

The US economy has continued to stride ahead. In spite of the occasional data disappointment, growth momentum in the United States is still thought to have been strong in the third quarter of 2014 after an annualized gross domestic product (GDP) number that was revised upward to 4.6% for the second quarter. The nonfarm payroll figure for September was particularly good, and data for July and August were revised quite substantially higher. Headline figures for output and employment have now passed their pre-recession peaks. In particular, the drop in the US unemployment rate to 5.9% in

September—the first time it has dropped below 6% since July 2008—due to a surge in private sector payrolls has prompted renewed debate about the timing of US Federal Reserve (Fed) monetary tightening.

Yet while the US economy is growing strongly again, there are still issues in the US job market and inflation remains low. As a consequence, voting members on the Federal Open Market Committee (FOMC) generally remain dovish. A September 17 statement from the Fed continued to point to the need to keep base rates at or close to zero for a "considerable time" and noted the "significant underutilization of labor resources." On the latter factor, the Fed can point to the stubbornly high number of people who are in part-time work but seek full-time employment: 7.1 million in September, according to the Bureau of Labor Statistics (BLS). In addition, the labor force participation rate declined in September to a low of 62.7%, a rate not seen since the late 1970s and well below the annual average of 67.1% seen in the late 1990s. Labor force participation rates for prime age workers—defined as those ages 25 to 54—have also declined.

Low inflation is also helping to take the pressure off the Fed to raise rates. Both core and headline inflation rates remain well below the Fed's unofficial target of 2%. Core personal consumer expenditures (PCE), a price indicator that the Fed frequently focuses on, was an annualized 1.5% in August. In spite of the general improvement in nonfarm payrolls, wage inflation has yet to be seen. Reflecting the Fed's point about continued slack in the labor market, average hourly wages actually fell in September and were up less than 2% from their level 12 months ago, according to BLS statistics. The strong US dollar, along with falling commodity prices and disinflation imported from other parts of the globe, has also contributed to weak price growth. Indeed, the FOMC minutes released from its September meeting underlined the extent to which Fed officials are concerned about dollar strengthening and weak growth outside the United States.

Yet we still believe the overall strength of US job creation and declining unemployment will cause the Fed to shift gears. We therefore expect ever firmer hints from the Fed that it will tighten monetary policy. Indeed, generally positive growth data have caused short-term bond yields to rise somewhat in recent weeks (although gains have not been linear). At the same time, benchmark 10-year Treasury yields hovered around the 2.30% mark in mid-October, well off the 3.0% level they reached last December. Even lower Japanese and

European government bond yields are continuing to sustain demand for Treasuries, as is a fall in the US deficit (which has curtailed new supply) and fears about global growth. The result of a rise in short-term benchmark rates and a fall in long-term ones is yield-curve flattening, as investors demand a lower premium to hold long-dated bonds compared to short-dated issues. Conventionally, flattening reflects both the prospect of the Fed slowing the economy and of lower long-term growth, which seems reasonable, although we believe the Fed's activism in the longer part of the Treasury curve distorts the importance of flattening as an indicator of market sentiment.

Just as interesting is the persistent gap between financial markets and the Fed when it comes to expectations for benchmark rates. Median FOMC forecasts for benchmark rates up to end 2016 have risen consistently this year. The latest "dot chart" released by the Fed in mid-September showed the median FOMC forecast for the federal funds rate at 1.375% at end 2015 (up from a previous forecast of 1.125%) and 2.875% at end 2016 (up from a previous forecast of 2.50%). And yet by early October, Fed funds futures had barely begun to inch forward and remained far lower than the FOMC projections, suggesting the market is even more dovish than the Fed and does not believe in the sustainability of current US growth. Unless the Fed is wrong, the market will have to engage in the risky process of adjusting its expectations to align itself with Fed policy as economic data are released.

Global Economy Faces Challenge of "New Mediocre"

Continuing stagnation in Europe and Japan as well as the cooling of expectations for large emerging-market economies have continued to influence global sentiment. These concerns are reflected in the latest projections from the International Monetary Fund (IMF), which were released in early October. Despite the recent improvement in US growth, the IMF now sees global growth in 2014 at 3.3%, 0.4% lower than its April 2014 expectation.[1] The IMF has also lowered its global growth forecast for 2015 to 3.8%.[2] These rates are below the levels of global growth seen in 2010 and 2011 when economies were recovering from the global financial crisis, and they seem to point to what IMF Managing Director Christine Lagarde has termed a "new mediocre" in the world economy. True, the IMF's record as a forecaster has been patchy (Lagarde has had to apologize for the fund's

serious underassessment of the UK's near-term growth prospects), but the IMF's growth downgrades tally with relatively lower forecasts from the Organisation for Economic Cooperation and Development and the World Bank.

Some more sophisticated emerging economies—most notably in Asia, as well as Mexico—have benefited from the improvements in the United States and from prudent macroeconomic policies, but growth in a number of commodity-producing countries is generally seen as underperforming expectations. Geopolitical tensions in the Middle East and Ukraine have not, as yet, led to an upsurge in commodity prices—quite the reverse, in fact, as supply has outstripped demand. Thus, many investors have begun to show concern about the prospects for countries that show relatively high inflation and run persistent current account deficits. These concerns have begun to manifest themselves in sliding currencies and pressure on local-currency bonds. Together with a surge in the US dollar and the progressive winding down of monthly liquidity injections provided by the Fed, it seems natural that emerging-market assets should have turned volatile of late as investors begin to eye the prospect of higher benchmark rates in the United States, which reduces the relative yield pick-up offered by emerging markets and exposes them to currency volatility.

We think close attention should be paid to an uptick in market volatility in countries that run twin budget and current account deficits. At the same time, we believe the wholesale reforms under way in China are likely to lead to lower, albeit more sustainable, growth and could pose challenges for other fast-growing markets in China's neighborhood. Nonetheless, emerging markets should not be dismissed *en bloc*, in our view. Signs of slowing economic activity in China have appeared, but a succession of "mini-stimuluses" should mean the country's GDP growth for 2014 is not far off the government's target of 7.5% for this year. Although the pace of China's growth has diminished, we believe it is actually trending toward higher-quality, more sustainable growth patterns. Meanwhile, data showing 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, could implement long-awaited economic reforms. This optimism has been reflected in the Indian rupee, which, unlike many other emerging-market currencies, was still stronger

against the US dollar at September 30 than at the beginning of this year. By contrast, Brazil entered recession in the second quarter, and its forecasts for growth in 2014 as a whole, as well as for 2015, have been revised downward. Brazil faces important issues stemming not only from the slowdown in China, but also from signs that a debt-driven consumer spending boom is coming to an end. Still, as in India, Brazil’s October general election could prove to be a market catalyst, whoever emerges as a winner.

On a bright note, by early October the rise in yields on emerging-market bonds was still much less pronounced than a year ago, when fears about imminent Fed unwinding of its monthly asset purchases led to significant volatility (the so-called “taper tantrum”). We think the “new mediocre” is not necessarily a fatality—emerging markets that have planned ahead for higher US interest rates may be able to cushion the impact of Fed tightening, if not nullify it altogether. The IMF highlighted that a willingness and improved institutional capacity to invest in subpar infrastructure throughout emerging markets could produce a virtuous circle of creating jobs as projects are built and removing bottlenecks once they are complete. In many places, there is significant opportunity to improve education, not to mention transport and housing policies. Ultimately, policy does matter, in our view.

European Outlook

Germany’s economy has shown signs of stalling, raising questions about the country’s status as the motor for whatever growth is present in the eurozone. German GDP declined by 0.2% in the second quarter, and business and consumer confidence have fallen consistently in recent months. The decline in the country’s prospects was underlined by a fall in German factory orders in August at their fastest pace in nine years and by the fastest declines in industrial production and exports in five years in the same month. The sharp downturn in Germany’s prospects has allowed critics of government policies to give full vent to their worries about chronic underinvestment in road and energy infrastructure. Observers also note that the country stands to lose more from a prolonged standoff between the West and Russia than any other major European power, while Germany’s high value-added exports tend to be less currency sensitive than those of France or Italy, which are likely to benefit more from the ongoing slide in the value of the euro.

But the weakness of the German economy appears to be confined to manufacturing. The services sector seems to be doing just fine, with consumer spending actually rising somewhat thanks to low unemployment and rising wages. And at least the recent weakness in manufacturing may help further the case of those who want Germany to do more to dig the eurozone out of stagnation by spending more of the large current account surplus it built up, which is seen as sucking up demand for goods from other eurozone countries.

But pleas for the Germans to do more might receive a more sympathetic hearing if they saw that the other two major eurozone countries, France and Italy, were more resolute in reducing their budget deficits. At the beginning of October, France announced a budget that pushed back until 2017 the date it expects to reach the European Union-designated deficit target of 3% of national income. This is the third time that the deadline has been pushed back, and it has done little to improve the current Socialist government’s credibility among its European neighbors. Governments in Greece, Portugal and Ireland were forced to implement steep budget cuts that seriously depressed their economies. Yet, not for the first time, the French seem to believe their economy’s size allows them to play by different rules. Italy is further down the road to closing its budget deficit, but it too has had to lower expectations of when it will achieve a balanced budget (2017). Additionally, Italy faces even greater challenges than France in terms of debt burden and medium-term growth potential. These challenges appear to be growing by the day as economic slowdown combined with disinflation make fiscal consolidation more difficult to implement.

In spite of bright spots like Ireland and Spain, the eurozone economy as a whole continues to flounder, with the IMF forecasting an almost 40% chance of the eurozone re-entering recession in mid-October. Forward indicators have not been propitious. As new orders contracted, a key composite purchasing managers’ index reading for the eurozone manufacturing sector fell in September to a level barely above the 50 line that divides expansion from contraction.

European leaders thus seem to be engaged in an increasingly shrill debate about the relative merits of short-term austerity aimed at medium-term gain versus the need to allow more fiscal slack in the short term to boost demand. What also cannot be ignored is the sheer historical difficulty of removing structural rigidities in both France and Italy,

which means their leaders have to tread lightly in bids to cut public spending. The far more flexible UK economy faces an even more acute deficit problem. Recent pickups in tax receipts have been offset by a rise in spending, interest payments and investment, leaving the UK budget deficit far higher than in either France or Italy. Yet, unlike the French and Italian authorities, the British government is in a position to tackle this problem from a position of some strength, with UK employment at an all-time high and the UK economy purring along at an annual growth rate of 3.2% in the second quarter, according to the Office of National Statistics.

European Central Bank (ECB) President Mario Draghi still expects eurozone growth to pick up some momentum. Imported inflation should also rise with the fall in the euro. A steep fall in the euro on a trade-weighted basis would boost the eurozone economy, especially if the Fed moves to raise interest rates earlier than expected. Draghi also can take some heart from good eurozone retail spending figures for August. Though volatile, retail sales data are typically a proxy for household demand, one of the weaker elements of the eurozone recovery that stalled in the second quarter.

Draghi is pinning much of his hope on a progressive improvement in credit conditions. In particular, the ECB expects that its latest offer of cheap loans to banks and its plans to buy asset-backed securities (ABS) will boost lending. However, early results from some of the ECB’s latest stimulatory measures have been less than satisfactory, with lackluster demand from banks for the first tranche of its targeted long-term refinancing operation facilities. A certain amount of skepticism has also greeted the ECB’s plans to revive the small European ABS market.

Meanwhile, consumer inflation in the eurozone dipped from 0.4% in August to 0.3% in September, a five-year low that means monthly price rises are now at less than a fifth of the ECB’s target of below but close to 2%. Core inflation, which strips out volatile energy and food prices, dropped to 0.7% in September from 0.9% in the previous month. Thus cries for quantitative easing have grown, even though some analysts warn that the prospect of a flood of newly created ECB money will do little to restore vibrant growth in Italy and other struggling countries weighed down by weak confidence, rigid labor markets and uncertainty over government tax and spending policies.

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1. Source: World Economic Outlook, October 2014. © By International Monetary Fund. All Rights Reserved.

2. Ibid.

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