Global Economic Perspective: February

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Perspective From the Franklin Templeton Fixed Income Group®

Strong Jobs and Consumer Spending Data Point to a Resilient US Economy

Recent data released in the United States appear to vindicate the relatively upbeat assessment of the economy contained in the Federal Reserve's (Fed's) January 28 statement, which stated that "economic activity has been expanding at a solid pace." The Fed highlighted continued gains in employment, and another big rise occurred in the January nonfarm payroll figure alongside a drop in initial jobless claims. Already-strong nonfarm payroll numbers for November and December were also revised upward. The pickup in employment is contributing to a healthy rise in consumer spending, which accounts for almost 70% of US gross domestic product (GDP). Americans' spending power has also benefited from the 43% fall in oil prices in US-dollar terms between June and the end of 2014. Helped by easier credit, Americans have been using some of the extra money in their pockets to buy new cars, with January auto sales up almost 14% on a year earlier, according to Autodata. As a consequence, personal consumption rose by 4.3% in the fourth quarter, the biggest gain since the beginning of 2006, and much higher than the 3.2% rise in consumer spending seen in the third quarter. Consumer confidence has surged, with The Conference Board's consumer confidence indicator reaching its highest level in eight years in January.

We are also beginning to see wages rising, albeit tentatively. The latest Bureau of Labor Statistics' employment cost index revealed that wages and salaries increased by 2.1% in 2014, compared with a rise of 1.9% in 2013, and there were some signs that wage growth accelerated in the final quarter of the year. The January nonfarm payrolls report offered further evidence that slack in the labor market is being absorbed, with average hourly earnings 2.2% higher than a year earlier. In spite of the concerns about hourly wage growth, the total US wage bill is now well in excess of prerecession levels.

US economic growth did slip from an annual rate of 5.0% in the third quarter to 2.6% in the fourth, according to a first estimate released by the Bureau of Economic Analysis. On balance, however, in light of strong consumer and labor data, we continue to believe that growth prospects look good for the coming months, and we continue to think the Fed will move to normalize its interest-rate policy in the months ahead, although it undoubtedly faces a dilemma as a result of recent disinflation and international developments.

Many commentators focused on the Fed's addition of concerns about "international developments" to its January 28 statement. Indeed, global growth estimates for this year have been revised downward by both the World Bank and the International Monetary Fund, while there is a risk of further eurozone instability associated with the election of a radical left-wing government in Greece. The persistent rise in the US dollar on a trade-weighted basis since the middle of last year is generally weighing on the competitiveness of US firms and hurting export performance. Perhaps reflecting the overseas challenge, the pace of expansion in America's manufacturing sector slowed in both December and January, according to the Institute for Supply Management's purchasing manager index survey, while durable goods orders fell steeply in December from a month earlier, according to the Commerce Department, as business investment in the United States remains uneven and many firms appear reluctant to spend until they see further signs of strong long-term growth.

The weakness in business investment may also stem in part from the sharp cuts in oil-related capital expenditure in recent months. Yet cuts in oil-related investment allow for redeployment of corporate resources to other areas such as those catering to rising consumer spending. Such redeployment may take a couple of quarters to filter through into GDP reports.

Price rises have been running below the Fed's long-run inflation objective of about 2%. However, the Fed believes that tumbling inflation and inflation expectations are temporary, "largely reflecting declines in energy prices." And since it seems highly unlikely that we will see a further 43% decline in oil prices in the coming six months, we think it is reasonable to expect that inflation expectations will stabilize and, under the influence of rising wages, begin to increase somewhat. In short, we believe the disinflation engendered by the fall in oil prices will prove to be a one-off effect that may be giving a false sense of security to some investors who persist in believing that recent inflation data are symptomatic of a weak recovery that requires further, long, drawn-out Fed support.

All in all, we believe the slowdown in US GDP growth seen in the fourth quarter (compared with the two previous exceptionally strong quarters) is likely to be short-lived given the enormous tailwind provided by the fall in oil prices plus strong employment gains. We further believe the fundamentals of the US economy are strong enough to cushion the blow to growth from any economic weakness elsewhere in the world.

Global Markets Contend with Shifting Growth and Inflation Signals

The opening weeks of 2015 have been marked by interest-rate cuts in a number of important economies, including Australia, India, Canada, Singapore and, most surprisingly, Russia. China and South Korea have also cut rates in recent weeks. Others, most notably the United Kingdom, seem to be in the process of pushing back previously signaled rate hikes. Canada, Australia and Russia are currently undergoing income shocks due to falling commodity prices, which could well give way to asset price shocks, thus forcing central banks to act. By contrast, rate cuts in places like India and Singapore are perhaps more reflective of the increased room for policy maneuvering afforded by falling oil prices.

More generally, while monetary policymakers in Asia have to contend with declining headline growth in China, the reorientation of Chinese development toward domestic consumption should actually continue to stimulate these countries' exports, even as liquidity continues to filter into Asian countries courtesy of quantitative easing (QE) in Japan and the eurozone. A further stimulus to growth should come from new governments in countries like India and Indonesia that seem intent on overhauling their economies. For all the talk of slowdown and for all the volatility that might be expected to come with speculation about rate tightening in the United States, emerging markets as a whole are still expected to grow at a faster clip than developed ones.

Importantly, we see the decline in oil prices since mid-2014 as having a one-off effect on inflation. Unless we see further significant drops in oil prices from their current levels, we believe the impact on headline inflation will progressively fade, and the real underlying inflationary pressures from stronger growth should play out. Given the anticipated transitory impact of falling oil price on inflation rates, together with the stimulus provided by the price declines that have already occurred, central banks may well approach monetary easing more cautiously in the months ahead. It is perhaps noteworthy that the central bank of India, where growth has slowed in the past two quarters of fiscal 2014 and which has a history of high inflation, did not follow the January cut to its benchmark interest rate with a further one in February, with the Reserve Bank of India saying it preferred to wait for further signs of declining inflation. Similarly, in early February, Turkey's central bank resisted political pressure to lower interest rates, noting that inflation fell less than expected in January.

European Outlook

The eurozone has received two large jolts in recent weeks, each with potentially wide-reaching effects. The first came with the unveiling of a QE package that will see the European Central Bank (ECB) push at least €1.1 trillion into the European economy in a bid to lift inflation and hence growth. The ECB stimulus package represents quite a significant injection of money into the European economy, which has already been benefiting from the substantial fall in oil prices since the middle of 2014. QE is putting downward pressure on the euro, which is helping European exports. Nonetheless, the ECB itself has been careful to assert that while QE might help boost growth in the eurozone economy in the short term, it will not be enough to put it on a long-term, sustainable footing, which instead requires substantial supply- and labor-market reforms, especially among the eurozone’s southern members.

On the face of it, the drop in government bond yields as a result of QE is also positive for borrowing costs: With the exception of the Greeks, European governments are now able to borrow at historically low yields. At the beginning of February, Finland even managed to sell at auction a five-year bond offering a negative yield. But the fall in yields, prompted by buyers who expect yields will go even lower, clearly indicates that the wall of liquidity to be provided by the ECB is dominating fundamentals. By the end of January, as much as €1.5 trillion of euro area debt maturing in more than a year came with a negative yield, about one-third of the total, according to J.P. Morgan.[1] Eurozone QE has forced central banks elsewhere in Europe to make drastic moves to ease policy as their currencies have come under upward pressure. By early February, the Danish central bank, after four rate cuts in the space of a fortnight, was offering a negative 0.75% rate on certificates of deposit (a global record low) as part of its effort to keep the krone pegged to the euro, sending some of its government bond yields below zero. Before Denmark was subjected to a massive inflow of speculative money, the Swiss central bank also decided to impose negative interest rates on deposits, and Swiss bond yields have turned negative right across the yield curve.[2]

But one might also interpret the historically unprecedented slide in bond yields in Europe as a vote of no confidence in the eurozone’s ability to pull itself out of stagnation. Certainly, the nominal yield of less than 0.4% that German 10-year Bunds were offering in early February shows little faith in the ECB’s ability to meet its inflation target of around 2%. German 10-year government borrowing costs have plummeted more than 3 percentage points since 2011, while 30-year German paper was yielding less than 1% in early February—the lowest level ever, and even below the levels offered for Japanese paper of similar maturity. For some observers, the low yields reached on the Bund, widely perceived as Europe’s ultimate perceived save haven, point to fears that Germany and the eurozone as a whole face a version of “Japanification” marked by negative inflation and low growth. Such fears seem overdone to us: Forward indicators point to a progressive improvement in Europe this year as QE kicks in, while the effect of the fall in oil prices in 2014 should soon fade out of rolling inflation statistics.

Low rates seem an anomaly considering solid jobs growth in Germany during the last couple of years and the rise in imported inflation caused by a weak euro. Yet Germany slipped into deflation in December and January, with weak wage growth compounding the effects of plummeting energy prices. Nominal growth, the slide in bond yields seem to suggest, looks set to be extremely low, just as it has been in Japan.

The relative scarcity of government bonds in Europe argues for the trend toward negative yields to go further. Banks have had to increase their holdings of such securities to meet increasingly stringent capital requirements, and it seems unlikely that they would sell these holdings for cash in euros especially as the ECB offers a negative deposit rate, meaning it taxes the banks for the privilege of depositing cash. Unless the banks are given something in return, why sell bonds to the central bank? Additionally, institutional investors face regulatory constraints on selling their eurozone government bond investments, which also constitute a core component of central bank reserves. Furthermore, while the European Union allows member countries to run a deficit of up to 3%, Germany balanced its federal budget in 2014 and intends to do so again in 2015. As such, net new supply of Bunds is highly limited. Overall, in spite of rock-bottom interest rates, European sovereign bond issuance is predicted to fall more than a 10th this year, according to Deutsche Bank calculations,[3] as countries in worse fiscal condition than Germany continue to pare their deficits. So, as the ECB readies itself for bond-buying, who are the sellers going to be?

The ECB's efforts to improve the eurozone's prospects also face challenges on the political front. Following Greek parliamentary elections in late January, the rise to power of an unlikely coalition dominated by the radical leftists of Syriza now presents the European authorities with an unprecedented situation of having to deal with a government that openly defies the conditions attached to Greece's bailout program and is seeking its wholesale renegotiation. Among the new government's first decisions were ones to raise the minimum wage by 30% and stop the country's privatization program.

Greece faces enormous hurdles in trying to deal with a public debt mountain equivalent to 175% of GDP and debt repayments made even more difficult to meet because of deflation. German Chancellor Angela Merkel has ruled out any cancellation of Greece's debt, pointing out that the country has already received substantial cuts from banks and creditors. But given the stakes involved—and given deposit flight from Greek banks and a spike in Greek government bond yields—some form of compromise will likely need to be found. Michael Noonan, Ireland's finance minister, has pointed out that the question of debt writedowns or cancellations did not really arise as government debt was rarely repaid—it was simply refinanced. The key, Mr. Noonan said, was to restructure debt in such a way that servicing it became affordable. Ireland—the most successful eurozone member to emerge from international bailout—had engaged in a number of debt restructurings over the years to make it progressively more affordable, Mr. Noonan noted. In our view, there is no reason the Greeks cannot achieve the same result through negotiation, especially as the necessary ingredients for Greek revival—growth, competitiveness, and sustainable debt and deficits—are hardly a mystery. Alas, despite vague expressions of support, the missing glue is trust among Greece's European partners that it can mend its ways within any reasonable framework of time. Will Greece manage to stay in the eurozone? Certainly, politicians (and bankers) throughout Europe have committed themselves to ensuring that it does. But with growth picking up, the rush to buy Bunds that offer no yield and the appreciation of currencies like the Swiss franc and Danish krone could be pointing to investor fears of a eurozone breakup.

Although obscured by Greek antics, other European economies appear to be chugging along relatively well and are set to lift their performances further in the short to medium term thanks to euro weakness, the fall in oil prices and QE. In spite of deflation, Spain managed to record GDP growth of 1.4% over the course of 2014, its best performance by far since the start of the sovereign debt crisis, while the German economics ministry increased its forecast for growth this year to 1.5% (the same as in 2014) from an earlier forecast of 1.3%. Eurozone unemployment has started to drop (albeit modestly), while credit growth has also begun to pick up and might be expected to increase further in the months ahead as QE kicks in. The ECB's January bank lending survey pointed both to a pickup in demand for borrowing for fixed investment and a greater willingness by banks to lend, while sentiment indicators have also been improving. Deflation remains a concern (consumer prices fell at an annual pace of 0.6% in January, according to Eurostat) but has been distorted by the fall in oil prices. There is no indication that falling prices are preventing many Europeans from spending—indeed, retail sales data from Germany, France and Spain showed a strong end to 2014, beating economists' forecasts, while the European Commission has raised its forecast for eurozone GDP growth to 1.3% this year and 1.9% in 2016. The coming year or two will tell whether these signs of modest eurozone improvement are anything more than the economic equivalent of a "dead cat bounce."

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1. Source: JP Morgan, *Global Data Watch,* 1/30/15, p. 9.

2. The yield curve is a line graph that allows for quick comparison of yield of similar bonds (usually US Treasuries) with different maturities.

3. Source: Deutsche Bank Market Research, *Eurozone 2015 Issuance Outlook,* 11/20/14.

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