Global Economic Perspective: March

March 17, 2015

Perspective from the Franklin Templeton Fixed Income Group®

IN THIS ISSUE:

- **United States Prepares for Interest-Rate Hikes**
- **But Much of the World Is Still in Monetary Easing Mode**
- **European Outlook**

United States Prepares for Interest-Rate Hikes

The US economy remains in fine form, in our view. Job creation has remained very strong, with gains in nonfarm payrolls coming in at a three-month average of 288,000 through February. In other words, US firms added almost 900,000 net new jobs in the past three months, helping reduce the unemployment rate to 5.5%. With the increasing number of people employed, aggregate private payrolls have increased at a rapid pace of 5.35% year-on-year at end-February, according to the Bureau of Labor Statistics. And there are

now even signs that per capita wage inflation may finally be kicking in. Wage earners' bargaining power has remained weak, with hourly earnings up just 2% in February, compared with a year earlier. However, combined with the rising value of their homes and equity portfolios, in broad terms, as well as the steep drop in oil prices, many Americans' personal finances have undoubtedly improved. This increase in aggregate wages has fed into robust readings for consumer spending—about two-thirds of economic activity—which expanded at an annual rate of 4.2% in the final three months of 2014.

But some economic data points have flagged a bit in recent weeks in the United States, pointing to good rather than exceptional growth prospects. Gross domestic product (GDP) grew by 2.4% in 2014 overall, but in the fourth quarter, growth came in at just 2.2%—well off the 5% pace seen in the third quarter. The Institute for Supply Management's purchasing managers index showed a slowing in manufacturing expansion for the fourth consecutive month in February, while auto sales and construction spending slowed in January—perhaps in part because of severe weather in many parts of the country. A harsh winter may also explain why US consumer sentiment fell from January's 11-year high in February.

The fall in oil prices has impacted consumer price inflation, which fell sharply in January. However, there appears to be little reason to worry about deflation in the United States, as nominal interest rates are very low and very flexible. Aggregate demand in the United States has remained robust, and we believe the fall in oil prices that has led to negative inflation is positive for the economy overall. Besides, the large oil price declines seem to be over, having recently shown signs of bottoming out. With the deflationary impact of falling oil prices wearing off, and with wages and employment rising, we would fully expect headline inflation to rise again as the year progresses.

Additionally, core prices excluding energy and food have been much more stable: The core consumer price index came in at an annual rate of 1.6% in January, while core personal consumer expenditures—which the US Federal Reserve (Fed) refers to in its monetary policy deliberations—stood at an annual rate of 1.3% in the same month. When viewed alongside wage and job growth, the short-term drop in consumer prices does not signal to us any sign of a renewed recession, and may not deflect the Fed from gradually normalizing base interest rates from at or close to zero in the months ahead.

Market expectations for the federal funds rate—the overnight rate at which a depository institution lends funds maintained at the Fed to another depository institution—have remained much lower than Fed policymakers' median estimate for rates through end-2016, which appears to reflect a belief that the economic recovery is not robust and that deflation remains a threat. This is not our view. We think the US economy is currently in a kind of "goldilocks" scenario, with positive economic growth and low inflation. The financial sector has substantially healed its wounds since 2009, private debts are being reduced, and low oil prices are helping many households and companies alike. However, with the base effects of lower energy prices fading, the labor market tightening, and economic growth the order of the day, in our view, we should see inflation pick up later this year. Indeed, an increase in expectations that inflation is likely to rise has been priced into market valuations.

At the same time, 10-year benchmark US Treasury yields, though they have started to rise, remain low, still benefiting from strong foreign buying on the back of ultra-low yields in Europe and Japan, the lingering effects of the distortions caused by the Fed's last bond-buying program (which ended in October 2014), and a relatively benign view of the likely pace and size of short-term interest-rate hikes by the Fed. Even though the US economy continues to grow, these factors are containing the rise in benchmark bond yields for the moment.

But Much of the World Is Still in Monetary Easing Mode

The end of February and beginning of March saw central banks in both China and India lower benchmark rates. Indeed, with inflation rates easing throughout many developing countries, as well as throughout the developed world thanks to falling energy prices, monetary easing remains the order of the day, except in some countries facing unique challenges such as Russia and Brazil. Before these developments in China and India, Poland's central bank cut its benchmark rate by a deeper-than-expected 50 basis points (0.50%) to 1.50%, a record low. Like other non-eurozone countries in Europe, Poland is seeking to limit upward pressure on its national currency ahead of the European Central Bank's (ECB's) quantitative easing (QE) initiative, which began in early March. Slippage in fourth-quarter growth in Australia is seen as likely setting the stage for further cuts to

interest rates there, following the 25 basis-point cut (0.25%) enacted by the Reserve Bank of Australia in early February. Disinflation has been providing cover for all these central banks' actions.

However, it is perhaps more interesting to consider rate cuts in China and India as simply corollaries to broader reform moves in both countries. In India's annual union budget, unveiled on March 1, the government of Prime Minister Narendra Modi gave itself an extra year to hit its 3% budget deficit target, deciding instead to spend money on upgrading infrastructure. The government also promised improved efficiency in social welfare programs and introduced a meaningful cut in corporate tax. The Reserve Bank of India's 25 basis-point cut (0.25%)—announced just after the unveiling of the union budget and outside scheduled policy meetings (like a similar cut in January)—may be considered approval for the government's bid to boost Asia's third-largest economy, which has long trailed that of China.

In China itself, the economic growth target for this year has been officially reduced to "around 7%," compared with 2014 GDP growth of 7.4%. While still high, such numbers are well below the double-digit growth rates that China recorded just five years ago. But in China too, reforms are afoot. The country's authorities have been keen to stress that a slowdown in growth to more sustainable levels is inevitable as efforts continue to reduce the economy's reliance on fixed-asset investments and to increase the contribution from consumption and trade to a more balanced growth model. We believe this is a welcome bid to bring China's expansion under control and to reduce some of the excesses that developed in the immediate aftermath of the Global Financial Crisis. Monetary policy is to be used occasionally, as it was at end-February, to ensure that China's reversion to a "new normal" in terms of growth is not too brutal, but it is not a sign of a heavy-handed campaign to restore double-digit growth.

Some observers believe that emerging markets in general could prove vulnerable to further US-dollar strengthening ahead of possible interest-rate hikes by the Fed, especially as many emerging markets continue to loosen monetary policy. But while further strengthening of the US dollar against the euro and the Japanese yen can be expected, given the expansionary monetary policies being implemented in Europe and Japan, we believe the performance of emerging-market bonds and currencies should prove to be

more differentiated. Countries with weak fundamentals and large financing gaps are likely to face greater challenges than those with stronger fundamentals, particularly those with strong cyclical ties to the US economy. Of note is the relative stabilization in the value of a number of currencies, including the Mexican peso, Malaysian ringgit and Chilean peso against the US dollar, during February.

European Outlook

Europe’s mood seems to have turned noticeably more positive in recent weeks—helped, no doubt, by a tenuous pre-agreement between Greece and its European partners that will see its creditors extend its bailout agreement by a few months. Economic news has also become more upbeat, enabling the ECB to raise its forecast for 2015 GDP growth in the eurozone to 1.5%, compared with a forecast of 1% as recently as December. The European Commission’s economic sentiment indicator rose to a seven-month high in February. Eurozone unemployment fell to 11.2% in January compared to 11.8% a year earlier, according to Eurostat, with jobless numbers starting to drop decisively in countries such as Ireland and Spain. Additionally, the number of employed people has reached an all-time high in Germany, finally pushing domestic demand higher in what many observers regard as Europe’s most important economy. Bank lending in the region may also be about to turn after three years of decline—lending to the private sector ebbed just 0.1% in January compared to a drop of 0.5% in December—as business confidence ticks up. Moreover, through the launch of the ECB’s QE program on March 9, the central bank will also be helping to grease the wheels of a European economy that has already been benefiting from the drop in the value of the euro and the slide in oil prices.

Strong investment and consumer spending in Germany led to an upward adjustment in GDP growth in that country to an annual rate of 1.5% in the fourth quarter, and domestic demand lifted Spain’s GDP by an annualized 2% for the same period. Outside the eurozone, the UK economy has forged ahead, helping the FTSE 100 Index, a gauge of UK equities, to reach all-time highs by the end of February—a remarkable result considering the highly uncertain outcome of May’s general election. A drop in imported inflation and a strengthening labor market continue to propel UK GDP growth, which seems likely this

year to emulate (at least) the 2.7% rate seen in the fourth quarter of 2014. Elsewhere, the Swedish economy grew 1.1% in the last three months of 2014, the strongest quarterly growth rate in almost two years and twice the consensus forecast.

Deflationary pressures remain an issue in the region, but they have not stopped countries like Spain, Ireland and Germany from showing robust growth indicators. Retail sales in the eurozone rose for the third consecutive month in December. Even in Italy, which has been mired in economic decline for years, car sales rose by over 10% in January from a year earlier. Moreover, as growth potentially picks up and the base effect of the plunge in oil prices in the second half of 2014 fades, so the threat of deflation might be expected to recede somewhat. Figures from Eurostat showed that consumer prices across the European Union fell at an annual rate of -0.3% in February, compared to -0.6% in January, while inflation expectations have risen substantially. And though incontestably weak, core inflation (excluding energy) is still positive (+0.6% year-on-year in February) in the eurozone. Inflation-busting pay deals in the German manufacturing industry and the commencement of QE, together with oil prices that show signs of bottoming out, should equally ease deflationary worries.

But it is not clear that Europe can keep the spring in its step. The recovery in Europe remains unduly concentrated in Germany and a few other countries while others like France and Italy continue to lag. Demand remains anemic, and private and public debt burdens remain worryingly high in a number of places, not just Greece. QE and ultra-low interest rates are helping to buy time by reducing refinancing costs for governments and firms. But the debt overhang makes it hard to see the likelihood of a dramatic increase in lending activity. The European Commission has only recently published outlines for a capital markets union. For the moment, the European economy’s reliance on a convalescent banking industry for credit remains much higher than in the United States, and a legal framework that adequately recognizes losses is lacking. In addition, a sudden spurt in inflation could result in heightened financial market volatility, especially as a number of European governments are currently offering negative interest rates to issue debt. While Europe is at a different stage in the credit cycle than the United States, the repercussions for Europe of a sudden lurch in long-term US yields cannot be ignored either.

And the current favorable alignment of various factors (low interest rates, a low euro and low oil prices) could well be supplanted by the effect of increased political instability. Recent economic improvements are still not sufficiently manifest for a European electorate angry at years of austerity and financial crisis. The Greek crisis could easily flare up again —possibly in June when the current bailout extension comes to an end, by which point the result of the British general election will also be known. Although outside the single-currency bloc, Britain could well be the latest country in Europe where protest populism becomes firmly entrenched. It may soon thereafter be joined by Spain where Podemos, a movement inspired by the radical left's victory in Greece and with historical links to Venezuela's late President Hugo Chávez, seems set to make important advances in local and national elections this year.

To get insights from Franklin Templeton Investments delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

For timely investing tidbits, follow us on Twitter @FTI_US and on LinkedIn.

The comments, opinions and analyses presented here are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

This information is intended for US residents only.

What Are the Risks?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations,

economic instability and political developments. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity.

Posted in Fixed Income Tagged Christopher Molumphy, eric takaha, Franklin Templeton fixed income group, Franklin Templeton Global Bond Funds, Franklin Templeton Global Economic Perspective, global fixed income investing, global impact of monetary policy, investing in global bonds, John Beck, michael materasso, Roger Bayston

Important Legal Information

FINRA's BrokerCheck

You can check the background of your investment professional on FINRA's **BrokerCheck**.

Links can take you to third party sites/media, directly or through new browser windows. We urge you to review the privacy, security, terms of use, and other policies of each site you visit. You use any third-party site, software, and materials at your own risk. Franklin Templeton does not control, adopt, endorse or accept responsibility for content, tools, products, or services (including any software, links, advertising, opinions or comments) available on or through third party sites or software.

Franklin Templeton welcomes your feedback on this blog. To keep the conversation respectful and focused, please follow our current Commenting Guidelines. We review comments and reserve the right to block any comment or commenter, including those that we may deem inappropriate or offensive. We may block any comment or commenter whose posts include investment testimonials, advice, or recommendations, or advertisements for products or services, or other promotional content.

Questions or comments about your Franklin Templeton account or customer-service issues? Please contact us directly but never include account or personal financial information in your comments.

The comments, opinions and analyses are the personal views expressed by the investment manager and are intended to be for informational purposes and general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice. The information provided in this material is rendered as at publication date and may change without notice and it is not intended as a complete analysis of every material fact regarding any country, region, market or investment.

All investments involve risk, including possible loss of principal.

Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN/342-5236 or visit franklintempleton.com. Please carefully read a prospectus before you invest or send money.

Data from third party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user.

Franklin Templeton Distributors, Inc.

© 2017. Franklin Templeton Investments. All rights reserved.

Using this site means you agree to our **Terms of Use**

Click to view our Privacy Policy