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Beyond Bulls & Bears

Global Economic Perspective: August

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Perspective from the Franklin Templeton Fixed Income Group®

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US Job Figures Strengthen Prospects for Interest-Rate Hikes

Continued improvement in the labor market and overall economic growth mean that the United States continues to move toward tighter monetary policy in the coming months, in our view. Initial estimates showed second-quarter US economic growth coming in at an annual rate of 2.3% (about average for this economic cycle), while the figure for the first quarter was revised upward from -0.2% to 0.6%. There was a further solid nonfarm payroll

figure for July, while revisions showed employers added more jobs in May and June than previously estimated. In addition, auto sales have remained healthy, as has the housing sector. Activity in the US services sector (over three-quarters of the US economy) grew at the fastest rate in July since the end of the recession in 2009, according to the Institute for Supply Management (ISM), suggesting that the US economy is on a strong footing and that growth could accelerate in the months ahead.

In late July, the US Federal Reserve (Fed) dropped a subtle hint that it was ready to move on base rates when it shifted away from a previous statement that it would raise rates once it had seen “further improvement” in jobs to one that said it needed to see just “some further improvement.” Then, in early August, the president of the Atlanta Federal Reserve, Dennis Lockhart—considered a centrist among voters on the Federal Open Market Committee—said that only major weakness in data would stop him from backing a short-term rate hike as early as September. The latest nonfarm payroll figures showed little sign of such weakness. The July figure (+215,000) marked the 58th consecutive month of job gains in the US economy, the longest stretch on record. In spite of some weakness earlier this year, monthly nonfarm payroll figures averaged well above 200,000 per month in the first seven months of 2015.

Nonetheless, there are plenty of reasons for the Fed to be cautious. Revisions to gross domestic product (GDP) data going back to 2012 show the current expansionary cycle (which began in the third quarter of 2009) is the weakest since World War II. The growth in wages has not tracked a tightening jobs market, with private-sector wages rising by a modest annual rate of 2.2% in the second quarter, compared with 2.8% in the first. A labor force participation rate that remained a relatively low 62.6% in July and evidence that a large part of the improvement in payrolls was due to part-time jobs rather than full-time ones point to continued slack in the workforce. Additionally, the ISM’s monthly manufacturing survey, while still growing, showed a slowdown in the rate of expansion in July, and productivity growth is still in the doldrums. Nor can the lack of inflation be ignored: Core personal consumption expenditures (excluding food and energy), a gauge the Fed pays particular attention to, has remained stubbornly low in recent years and rose at an annualized rate of just 1.3% in June, well below the central bank’s objective of around 2% core inflation.

The severe drop in commodity prices, while positive for the economy overall, has proved to be a drag on overall corporate investment, and second-quarter earnings reports revealed a slump in revenues for S&P 500 companies due largely to the performance of the energy sector. Nor are currency movements helping. After stalling, the US dollar has begun to climb again, hurting exports and adding to a growing trade deficit. An economic slowdown in China may also be starting to affect large US exporters.

In short, we believe sound headline job creation figures point to interest-rate increases by a Fed that would like to begin to “normalize” monetary policy when possible. The US economy is no longer in the emergency room, as it was in December 2008, when short-term rates fell to their current level of “at or close to zero” and where they have remained ever since. Sluggish wages and an uncertain global picture may not be enough to stay the Fed’s hand in circumstances in which the US unemployment level has fallen close to 5%. At the same time, Fed Chair Janet Yellen has been cautious in her comments about interest-rate rises, conscious that growth remains modest and anxious to minimize market disruption. It therefore looks likely that rates will be increased gradually and in small steps. And indeed, Fed officials have been at pains to point out that the path for rates in the medium and long term is more important than the exact timing of the first base-rate hike in nine years.

Global Economy Faces Up to Short-Term Challenges

As the Fed appears set to lift official borrowing rates for the first time in nearly a decade, currencies of emerging markets and commodity exporters have come under increasing pressure, exacerbated by the slowdown in China. In the first seven months of 2015, the Brazilian real lost almost 30% against the US dollar, while the Australian and Canadian dollars and the Chilean peso each lost over 10%. The disaffection for emerging markets in particular can be seen in equity indexes, with the MSCI Emerging Markets Index falling by over 13% in the first seven months of 2015, and emerging-market funds experiencing significant outflows.

And while Europe and the United States seem to have steadied their economies, the outlook for the global economy at large is only fair to middling. On July 9, the International Monetary Fund (IMF) cut its forecast for 2015 global growth from 3.5% to 3.3%. Demand

indicators pointing to sluggish activity in a number of large emerging-market economies underscore this slowdown. In volume and value terms, global trade has been falling, while the JP Morgan Global Manufacturing PMI (purchasing managers index) has sagged in recent months.

In many countries, central banks have been trying to ease economic conditions by lowering policy rates, but they have been constrained by the need to defend the local currency against a rising US dollar. Indeed, currency pressures have recently forced central banks in South Africa and Brazil to hike rates in spite of economic fragility. Yet we are not convinced there will be a repeat of the Asian crisis of 1997–1998, or even of the “taper tantrum” of 2013, when the Fed first indicated it would begin reducing its bond-buying program. Renewed attention is rightly being paid to the buildup in leverage in a number of countries in recent years, often dollar-denominated, but that leverage has tended to be concentrated among corporations rather than sovereigns. Most of the dollar pegs that caused problems in the past have given way to floating currencies, which tend to allow for smoother adjustments to changing circumstances. And while the United States is likely to start tightening policy rates, the global economy should benefit from continued policy easing in China, Japan and the eurozone.

Improved US and European economies are good news for the rest of the world, as are stabilization in China and the commitment of the authorities there to foster domestic growth. On the latter point, the news is relatively positive. The Chinese economy grew at an annual rate of 7% in the second quarter, the same rate as in the previous quarter, and trade figures for June also suggested the Chinese economy may be stabilizing. While recent data have been somewhat muted, the IMF expects the global growth rate and the growth rate for emerging markets to pick up again in 2016. However, uncertainty about the true state of the Chinese economy was ratcheted up when China devalued the renminbi in August. The decision was seen as a further sign of economic weakness in China. An orderly approach to devaluation could indeed help China regain some momentum, but it could also hurt the attractiveness of other countries’ exports and contribute to global deflation.

At the same time, we believe it is important to burrow deep into the dynamics at work in individual countries before drawing conclusions. We further believe that growth in important markets such as China, India and Mexico could be propped up by a sustained reform drive. Countries such as South Korea, Taiwan, Chile, Indonesia, Thailand and a range of Middle-Eastern countries are also engaged in a (sometimes painful) reform process that involves opening up markets and curtailing subsidies of one kind or another. Thus, while the Mexican peso has slid, for example, foreign investors have continued to buy Mexican local-currency sovereign bonds in recognition of Mexico’s modest current account deficit, below-target inflation and the implementation of fiscal austerity measures to make up for falling crude oil prices. Proposed trade pacts (including the Transatlantic Trade and Investment Pact between the European Union and the United States, as well as the Trans-Pacific Partnership between Pacific Rim countries) could also improve growth prospects.

The shorter-term picture is cloudier elsewhere. The commodity-dependent Russian economy is in the midst of a deepening recession, though Russia is largely isolated from global financial markets. Brazil too is seeing slow growth as the changing nature of the Chinese economy feeds into lower commodities demand. However, Brazil could start to see more balanced growth as weaker commodities demand provides a spur to other sources of development, and there are already signs that the country is moving toward more disciplined fiscal policies.

Greece an Outlier as Europe Continues to Recover

Although the prospect of a Greek exit from the eurozone has faded momentarily, Greece has not strayed far from the headlines since an agreement was reached on July 13 to discuss a third financial bailout for the country. Private-sector business activity in the rest of the eurozone has remained buoyant, with the closely watched Markit composite PMI for the currency area still comfortably above the 50 level that separates expansion from contraction. Eurozone GDP grew at a quarter-over-quarter rate of 0.4% in the first quarter and may well have achieved a similar level of growth in the second quarter, with former crisis countries like Spain and Ireland roaring ahead, helped by the European Central Bank’s (ECB’s) monetary stimulus, a weak euro and falling energy prices. Some observers have voiced fears that spillover from the Greek crisis might start to hit sentiment in the

rest of the eurozone. But the effect thus far has been slight. Although Markit's PMI index for the manufacturing sector slowed in July, it still showed continued expansion in most of the 19 members of the eurozone. Greece itself was a glaring exception, with the manufacturing index plunging to a record low of 30.2 as Greek industry began to pay the price for its government's standoff with Europe. The Greek economy contracted in the first three months of this year. With capital controls still in place, political uncertainty the order of the day, talks over Greece's new bailout still needing to be completed, and a series of debt repayment deadlines looming, renewed recession is the last thing that Greece needs, but it seems likely. The gulf that separates Greece from the rest of the eurozone therefore continues to widen.

At the same time, with growth faltering in many other parts of the world, it is not clear how the eurozone would cope without the massive amounts of liquidity provided by the ECB through the purchase of €60 billion in mostly government-backed bonds every month since March. Surveys suggest that bank lending to businesses has been picking up only gradually and unevenly, recent improvements in unemployment seemed to stall in June, and inflation is still well off the ECB's medium-term target of "below but close to 2%," with headline annual inflation coming in at just 0.2% in the eurozone in July, according to Eurostat. Core inflation (which strips out volatile energy and food prices) was a more respectable 1% in June, and even the headline rate has improved since the negative numbers recorded at the beginning of this year. But inflation expectations have remained low, and the threat of deflation has not disappeared entirely—and could conceivably be imported from emerging markets.

In short, low inflation and modest economic growth continue to point to a prolonged period of highly expansionary monetary policy in the eurozone and, therefore, to a growing divergence between it and the United States, along with the United Kingdom.

Indeed, the latter country is, like the United States, moving cautiously closer to tightening monetary policy. The United Kingdom's Office for National Statistics released a preliminary estimate for UK GDP growth of 0.7% in the second quarter, up from 0.4% in the first quarter. The country is nearing full employment, and wage pressures have been growing. Still, inflation remains at zero, well below the Bank of England's (BOE's) target, and British exports have been feeling the effects of sterling strength. On August 6, policymakers were

able to point to a downgrade in the BOE's own short-term forecasts for inflation and a more cautious outlook for the labor market to justify leaving base rates at 0.5%. In addition, data for July began to point to some slowdown in housing and the all-important services sector, while renewed weakness in oil prices may well allow the BOE some more breathing room before it moves. In any case, the BOE's governor, Mark Carney, has been hinting that any increase in borrowing costs will be gradual and will stop at a level lower than in the past.

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