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Global Economic Perspective: February

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Perspective from Franklin Templeton Fixed Income Group®

US Economic Fundamentals Constructive, But Political Realities Suggest Year of Moderate Growth

For all that political events and speculation about policy direction have dominated news cycles over recent months, the US economy's key fundamentals have changed remarkably little, in our view. The backdrop appears to us to be constructive, as a healthy level of consumer spending has been increasingly reinforced by a recovery in corporate earnings and investment. With sentiment boosted by the US election result, the economy may pick up a little speed over the rest of 2017, but we think a significant near-term shift in its trend growth rate is unlikely, as delivering effective policy change is both difficult and time-consuming.

Stability of Chinese Economy Bodes Well For Slight Improvement in 2017 Global Growth

The outlook for the global economy appears a little better, in our view, and overall growth in 2017 could well show a slight improvement from a year ago. The stability of the Chinese economy is encouraging, and surveys in many parts of the world suggest confidence has increased. But we would caution against any expectations of a strong pickup and believe there may well be increased volatility ahead for global markets, given the extent of the moves seen in some asset classes in recent months.

Increases in European Growth and Inflation Unlikely To Sway ECB

Despite stronger-than-expected growth and inflation figures, the forthcoming political calendar seems likely to keep the European Central Bank (ECB) in accommodative mode for a while yet. We think any major change in the central bank's monetary policy will be delayed at least until after the German elections in September. The uptick in headline inflation has led to some calls for an early move by the ECB to reduce the scale of its bond purchases, but with core inflation showing little sign of moving toward the central bank's 2% target in the short term, we believe such a policy shift remains some way off.

US Economic Fundamentals Constructive, But Political Realities Suggest Year of Moderate Growth

For all that political events and speculation about policy direction have dominated news cycles over recent months, the US economy's key fundamentals have changed remarkably little, in our view. Growth is still range-bound in the 2% zone that has predominated in recent years, though the backdrop appears to us to be constructive, as a healthy level of consumer spending has been increasingly reinforced by a recovery in corporate earnings and investment. With sentiment, particularly among businesses, boosted by the US election result, the economy may pick up a little speed over the rest of 2017, although we feel it will probably not be to the extent some have predicted.

This uptick in sentiment has been clearly reflected in financial markets, as most participants seem to have focused primarily on a possible upcoming boost to growth through fiscal and regulatory initiatives, and do not seem to have allowed for the likelihood of any problems or delays down the road. However, delivering effective policy change is both difficult and time-consuming, which we think makes a significant near-term shift in the US trend growth rate less likely, though there is potential for market volatility to increase as the political process unfolds. Setting aside the multiple scenarios for the paths to be taken by the new administration, we feel confident the US economy is on a solid footing, and well placed to maintain and perhaps slightly increase its rate of expansion over the rest of the year.

Emphasizing the economy's current range-bound growth, the initial reading for fourth-quarter 2016 gross domestic product growth came in below consensus expectations at 1.9% on an annualized basis. It was again affected by volatility in transitory factors, notably a reversal of a third-quarter surge in overseas demand for soybeans. However, elsewhere the data showed growth in consumer spending—the key driver for the US economy—remained solid at 2.5%. Encouragingly, there was also a reasonably strong rise for business investment in equipment after four consecutive quarters of declines. In part, the rebound reflected renewed opportunities for the energy sector following the recovery of oil prices, which was also evident during the reporting season, as many companies engaged in the location and extraction of oil and gas sharply raised their estimates for capital expenditure during the coming financial year. The pickup in investment may also have signaled wider business expectations for potentially lower taxes and lighter regulation under the new administration.

Meanwhile, January's labor market report contained mixed signals. The 227,000 jobs added were well above consensus expectations of 180,000, although previous reports at the start of the year have sometimes been affected by seasonal distortions in sectors like retail and construction. A rise of two-tenths in the labor force participation rate to 62.9% underlined how the strong labor market has been attracting new entrants and former workers, and pushed the unemployment rate up slightly to 4.8%. The participation rate has been stuck at an extremely low level by historical standards since late 2013, and of the key data points closely monitored by the US Federal Reserve (Fed) to gauge how much slack still exists in the labor market, it remains the measure most out of kilter with levels seen before the global financial crisis.

The increase in the supply of labor may, to some extent, have explained the accompanying weakness in wage growth in the January report. Average hourly earnings were up only 0.1% from the previous month, and December's strong 0.4% monthly rise was revised down to 0.2%. As a result, January's annual figure fell back to 2.5%, a sharp drop from the six-year high seen at the end of 2016. There were few signs of immediate inflation pressures elsewhere either, with December's core personal consumption expenditures price index—the Fed's favored inflation measure—up a tenth to 0.1% month-on-month, while the year-on-year number remained at 1.7%, the same as November's revised reading.

On the whole, surveys measuring sentiment remained upbeat. Further signs of a pickup in the corporate sector were visible in the Institute for Supply Management (ISM) purchasing managers' index for manufacturing, which in January rose to its highest level since the collapse of oil prices in late 2014. The survey indicated continued strength in new orders and employment, while also highlighting rising input costs, mainly due to the rebound in commodity markets. The equivalent ISM report for services held steady at its recent higher levels, with a particularly robust reading for business activity.

As expected, the Fed left interest rates unchanged at its January meeting, but in its statement noted the widespread improvement in sentiment. Furthermore, the Fed re-iterated it expected to make further increases in interest rates as inflation moves toward its 2% target over the medium term, although there were no indications about the timing of such moves. Earlier, Fed Chair Janet Yellen had defended the pace of previous policy tightening, underlining that in her eyes, the data did not indicate overheating in the labor market. In other comments, some of her colleagues raised the possibility that if the economy did show signs of heating up too much, the Fed should start to reduce the size of its balance sheet, which swelled in the aftermath of the global financial crisis as the central bank bought Treasuries and mortgage-backed securities.

When shaping our views, we feel it is important to focus on what can be gleaned from current data, as opposed to extrapolating the numerous possibilities for policy change going forward. It seems to us the US economy is in moderately good shape, with a post-election upturn in sentiment currently reflected in financial markets. These solid underpinnings mean the economy's rate of progress should be broadly maintained over the rest of the year, in our view, with any significant shift in its growth trajectory unlikely to occur swiftly, or without some market volatility along the way.

Stability of Chinese Economy Bodes Well For Slight Improvement in 2017 Global Growth

Official data showed China's economy grew at an annual rate of 6.8% in the final quarter of 2016, and at 6.7% for the year as a whole, in line with the Chinese government's target. Though domestic demand has grown to represent an increasingly important driver for the Chinese economy, its export-oriented manufacturing sector has remained a key source of employment. Mindful of the damage any potential adoption of more restrictive trade policies by the Trump administration could cause, Chinese President Xi Jinping warned publicly about the dangers of a trade war. But moves by Chinese policymakers to reduce the country's high debt levels by tackling politically sensitive areas of the economy, particularly state-owned companies—which could well slow China's growth in the short term—seemed likely to be postponed until after the rotation of China's leading politicians, scheduled to take place at the end of 2017.

In a sign that hopes for stronger growth during the Trump era are not confined to the United States, the Bank of Japan (BOJ) raised its growth forecasts for the country's economy at its meeting in January, though the central bank's estimates for future inflation (which it has consistently overestimated) were left unchanged. The Japanese yen has recovered some lost ground in 2017, but has still seen a sizable depreciation against the US dollar since the US elections, boosting Japanese exporters, and the BOJ said it believed a potential pickup in overseas growth would help the economy further. The central bank maintained its existing monetary stimulus, and it later intervened in the Japanese government bond market to stem a recent rise in yields, doing so for the first time since the introduction of a policy in September 2016 that sought to cap benchmark yields at around zero.

Another currency that has been significantly weakened by the US elections is the Mexican peso, and Mexico's central bank has been forced to repeatedly raise interest rates in order to try to shore up the currency. Rising inflation—exacerbated in January by the Mexican government's decision to end fuel subsidies—has added to the need for tighter monetary policy, with official rates having nearly doubled in the last 12 months. Estimates for growth in 2017 point to a slowdown in the Mexican economy, as more than 80% of the country's exports go to the United States, and future US trade policy toward its southern neighbor remains uncertain.

In contrast, Russia's central bank unveiled plans to weaken the Russian ruble, which, due to the country's position as one of the world's largest energy producers, has rallied as oil prices have recovered. The move appeared aimed at helping to rebuild the country's foreign-exchange reserves, which were depleted by a currency crisis in late 2014 that was triggered by the collapse in energy prices earlier that year. The Russian central bank also predicted inflation was on course to decline further and hit its target of 4% by the end of 2017.

The outlook for the global economy appears a little better, in our view, and overall growth in 2017 could well show a slight improvement from a year ago. The stability in the Chinese economy is encouraging, and surveys in many parts of the world suggest confidence has increased. But we would caution against any expectations of a strong pickup and believe there may well be increased volatility ahead for global markets, given the extent of the moves seen in some asset classes in recent months.

Increases in European Growth and Inflation Unlikely To Sway ECB

Economic data showed the eurozone expanded by 0.5% in the fourth quarter of 2016 compared with the previous three months, which was marginally better than consensus expectations. Germany's expansion of 1.9% over the whole of 2016 was its fastest growth rate since 2011, while Spain registered 3.2% growth over the same period, and as the year ended, the French economy maintained its recovery from the contraction seen in the second quarter of 2016. The UK economy also put in a better-than-expected performance in the final quarter of last year, growing 0.6% quarter-on-quarter, leaving the United Kingdom as the fastest-growing member of the G7, and confounding predictions the country's growth would slow sharply following its mid-2016 vote to leave the European Union (EU). Even in Italy, which has been hobbled by an uncertain political backdrop and high levels of bad debt in its banking system, industrial production increased in 2016 by the most in six years. Indeed, surveys of sentiment among companies and consumers at the start of 2017 generally continued to indicate improvement across most of the eurozone, although there was still a notable divergence between the stronger economies and the weaker ones, with the latter group including Italy, Portugal and Greece.

Inflation in the eurozone also rose in January, with a 1.8% year-on-year increase in the headline rate marking the highest level in four years. Along with the recovery in energy prices, harsh weather in southern Europe—which pushed up food prices—was largely responsible. But in keeping with recent patterns, core inflation for the region remained steady at 0.9% over the 12-month period. At the ECB's January meeting, at which its policy was left unchanged, ECB President Mario Draghi underlined that he did not see any convincing evidence of inflationary momentum.

Politically, one of the main stories in Europe was a controversy surrounding François Fillon, the center-right's leading candidate in France's May presidential election. The story increased concerns among investors about the potential for the populist candidate Marine Le Pen to win the election, and widened spreads between benchmark French and German government bonds to their highest levels in four years. Elsewhere, the UK government moved closer to opening negotiations with the EU on the terms of the United Kingdom's exit, after gaining the UK parliament's approval to move ahead, leaving the government on course for its provisional start date of March.

Despite the slightly better-than-expected fourth-quarter growth figures for the eurozone, we are skeptical the region's expansion will accelerate over the rest of 2017. Though Germany and Spain have been doing well, other countries in the southern part of Europe, notably Italy, are still struggling to generate meaningful growth. With political uncertainty—in the shape of forthcoming French and German elections, and the potential difficulties of adjusting to any policy shifts on trade by the Trump administration—looming large, the backdrop is less than favorable and could result in periodic surges in market volatility. The other significant unknown is how the United Kingdom's negotiations on the terms of its exit from the EU will unfold, though it is hard to see how they can advance too far prior to the French and German votes.

The forthcoming political calendar also seems likely to keep the ECB in accommodative mode for a while yet. We think any major change in the central bank's monetary policy will be delayed at least until after the German elections in September. A current uptick in the region's headline inflation has led to some calls for an early move by the ECB to reduce the scale of its bond purchases, but with core inflation showing little sign of moving toward the central bank's 2% target in the short term, we believe such a policy shift remains some way off.

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