FIXED INCOME

Global Economic Perspective: July

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In this month's Global Economic Perspective, Franklin Templeton Fixed Income Group dives into diverging central bank policy and weighs in on whether the European Central Bank is likely to be less accommodative—and what its timing might look like.

Perspective from Franklin Templeton Fixed Income Group®

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Robust US Economic Fundamentals Support Fed's Gradual Tightening of Monetary Policy
We see little change in US economic fundamentals despite a modest rise in Treasury yields over the last month, which seemed largely due to a sharp selloff across many other global bond markets, rather than to domestic factors. The US Federal Reserve (Fed) appears to believe the economy's performance remains robust enough to continue with a gradual tightening of monetary policy and is inclined to downplay stubbornly low inflation data for the time being. With the labor market closing in on full employment, and consumers benefiting from firm housing and stock prices, we would concur with the Fed's assessment of the health of the underlying economy. Given such conditions, economic orthodoxy suggests inflation will pick up at some point, and this remains our core view.

Selloff in Global Bond Markets Follows Central Bank Comments
A selloff in many global bond markets occurred after comments by policymakers from a number of countries, which were widely interpreted as signaling a less accommodative monetary approach overall by central banks. The selloff may have stirred memories of the "taper tantrum" of 2013, but we believe it is important to recognize the difference in magnitude between the two episodes. With the Fed to some extent looking on during the current episode, rather than playing the central role as in 2013, the market moves have been less extreme in most cases. And equally importantly, there has been little sign of the retreat by investors from riskier asset classes that took place previously.

Draghi Speech Unsettles Markets amid Upbeat Eurozone Economic Data

A speech by European Central Bank (ECB) President Mario Draghi, referring to the emergence of reflationary forces, produced a sharp reaction in European markets, which we saw as somewhat exaggerated, given that inflation in the region has remained subdued. Even if a formal discussion about scaling back the ECB's monetary stimulus is imminent, such a move seems more likely to take place sometime in 2018, in our assessment. As for the longer-term trajectory for the ECB's monetary policy, we believe the central bank is likely to have a much longer path toward increasing interest rates than currently expected by many market participants, reinforcing our views on the potential for monetary policy divergence between the eurozone and the United States.

Robust US Economic Fundamentals Support Fed's Gradual Tightening of Monetary Policy

We see little change in US economic fundamentals, despite a modest rise in Treasury yields over the last month, which seemed largely due to a sharp selloff across many other global bond markets, rather than to domestic factors. The Fed appears to believe the economy's performance remains robust enough to continue with a gradual tightening of monetary policy and is inclined to downplay stubbornly low inflation data for the time being. With the labor market closing in on full employment, and consumers benefiting from firm housing and stock prices, we would concur with the Fed's assessment of the health of the underlying economy. Given such conditions, economic orthodoxy suggests inflation will pick up at some point, and this remains our core view, in the absence of more conclusive evidence that the late period of this cycle could diverge significantly from previous examples in this respect.

US economic data generally followed the mixed pattern seen so far this year. Softer readings included a monthly rise of only 0.1% in consumer spending in May, although much of the weakness was ascribed to low energy prices. More positively, the report contained a healthier monthly gain for spending on services, the largest category. But retail sales in May and June came in well below consensus expectations, as did some corporate data, notably May orders for durable goods, even when adjusted to exclude the more volatile transportation component of that report. There were also further signs auto sales were continuing to retreat from the record levels reached in 2016, as tighter financing and an increase in the supply of used vehicles increased pressure on new car sales.

The most significant offset to the weaker data was the payroll growth seen in June's labor report. The 222,000 jobs added were well ahead of consensus forecasts, and upward revisions to previous months' data left the three-month average for job gains at approximately 194,000, showing little sign of a slowdown in job creation, despite the past tightening of the market. The service sector was particularly strong, and a rise in temporary hiring suggested employers might be turning to contractors, after struggling to fill permanent positions. The unemployment rate ticked up a tenth to 4.4%, mirroring a similar rise in labor participation, as more people were encouraged to look for work.

However, June's employment report gave no hint wages were responding to the vibrant pace of payroll growth. Earnings failed to match consensus expectations and rose only 0.2% month-on-month in June, leaving the annual increase at 2.5%, while the equivalent figures for May were revised down to 0.1% and 2.4%. The lackluster wage growth echoed a similar tone in broader inflation gauges, with the core personal consumption expenditures price index—the Fed's favored measure of price growth—dropping to an annual rate of 1.4% in May, a third consecutive decline and its lowest level in 18 months.

As the minutes from the Fed's June meeting showed, most of the committee members were not unduly concerned about this ongoing softness in inflation, putting it down mainly to "idiosyncratic factors" such as cheaper cell phone bills and drugs. A few, though, did express fears that progress toward the Fed's 2% inflation target had slowed, and later remarks by Fed Chair Janet Yellen, which emphasized the close attention being paid to whether price pressures were at risk of stagnating, were seen as slightly more dovish than earlier indications.

Similarly, the Fed minutes illustrated differing views among policymakers on the potential implications of the tight labor market, given that the unemployment rate had moved close to or even below most prior definitions of full employment. Further detail was revealed about discussions related to the unwinding of the Fed's balance sheet, with the September meeting still a possibility for such a move to be announced. All in all, however, reaction to the release of the Fed's June discussions appeared fairly muted, and market participants remained divided on whether another rise in US interest rates would take place before the end of the year, as indicated by the Fed's own projections.

The relatively upbeat sentiment regarding the economy was by no means confined to Fed policymakers. Consensus estimates for second-quarter gross domestic product growth remained in the 2.5%–3.0% range, suggesting a strong pickup from the first quarter's latest reading of 1.4%, itself a healthy upward revision from the initial figure of 0.7%. There were further grounds for optimism in the strength of the June Institute for Supply Management purchasing managers' indexes (PMIs) for manufacturing and services. The surveys pointed to solid levels of employment, new orders, business activity and production, with the manufacturing PMI rising to its highest level since 2014. Another positive indicator was a quarterly survey of chief executive officers—canvassing their planned investment and hiring as well as projected sales—which hit a three-year high.

The signals coming from the Fed seem to indicate policymakers' clear desire to gradually normalize monetary policy, so how the pace of this normalization could be affected by domestic data and other factors continues to be the main focus for market participants. The possibility of future tax legislation and deregulation under the Trump administration and its potential to boost growth remains one of the key unknowns that could significantly impact the Fed's calculations.

Selloff in Global Bond Markets Follows Central Bank Comments

The selloff in many global bond markets came after comments by policymakers from a number of countries, which were widely interpreted as signaling a less-accommodative monetary approach overall by central banks. Remarks by European officials will be discussed in more detail below, but others adopting a more hawkish slant included Stephen Poloz, the head of Canada's central bank, who said he believed the Canadian economy's momentum showed that earlier cuts in interest rates had "done their work" in offsetting the impact of falling global energy prices on the Canadian economy over 2014–2015.

Investors scrambled to adjust to the Bank of Canada (BoC) governor's shift in tone, as market forecasts had previously predicted a rise in Canadian interest rates would not occur until early 2018. At its July meeting, the BoC duly raised rates by 0.25% to 0.75%, citing confidence in its outlook for "above-potential growth," but also acknowledging softer inflation. Over the intervening period, Canadian sovereign bond yields moved sharply higher, and in the wake of the BoC's decision, the Canadian dollar—which had lagged its G10 peers during the first five months of 2017—climbed to an 11-month high against the US dollar.

But one central bank that showed no sign of changing course was the Bank of Japan (BoJ), and at its meeting in June, Japanese policymakers re-iterated their commitment to a substantial level of monetary stimulus, as long as inflation remained so far from the BoJ's 2% target. Though the BoJ stated it would maintain its goal of purchasing assets up to a level of Y80 trillion, in recent months its purchases have fallen below that amount due to limited supply, prompting some debate as to whether the central bank was in fact tapering its stimulus without overtly acknowledging such a move. However, faced with the upward move in global bond yields, in early July the BoJ demonstrated its resolve to defend the policy of holding benchmark Japanese government bond (JGB) yields close to zero by offering to buy an unlimited amount of benchmark JGBs once yields had moved above 0.1%.

The BoJ did see an improvement in the Japanese economy, describing it as turning "toward a moderate expansion." Growth in the first quarter was trimmed back due to inventory adjustments, although it remained above the level of around 0.75% that is widely seen as Japan's long-term potential growth rate. The resulting five consecutive quarters of expansion have been the economy's longest such run for over 10 years. As in the United States, however, Japan's increased demand for workers has not produced any corresponding rise in wage pressures, even as its labor market appears to have tightened significantly.

The selloff in global bond markets may have stirred memories of the “taper tantrum” of 2013, but we believe it is important to recognize the difference in magnitude between the two episodes. With the Fed to some extent looking on during the current episode, rather than playing the central role as in 2013, the market moves have been less extreme in most cases. And equally importantly, there has been little sign of the retreat by investors from riskier asset classes that took place previously. While central banks such as the BoC have reacted swiftly to signs of increased activity, we believe others such as the BoJ will wait for a modestly firmer footing for their country’s economy to translate into higher inflation before altering their current accommodative stance.

Draghi Speech Unsettles Markets amid Upbeat Eurozone Economic Data

The biggest impact on bond markets came from a speech by ECB President Mario Draghi in late June, and in particular his assertion that in the eurozone “the threat of deflation is gone and reflationary forces are at play.” Market participants had been on alert for hints improving economic conditions in the region might soon persuade the ECB to scale back its monetary stimulus, and to many Draghi’s comments seemed to be a key shift in the central bank’s messaging, possibly preparing the ground for such a move. However, other parts of the ECB president’s speech received less attention, including the need for the central bank’s monetary policy to be “persistent.” This sentiment was later echoed by another senior ECB policymaker, who referred to the need for “patience and persistence” in achieving the central bank’s inflation target, as officials attempted to downplay the significance of Draghi’s remarks on reflation.

Nevertheless, the reaction in financial markets was swift, with the sharpest move coming in the German Bund market, as investors reconsidered whether its ultra-low yields were sustainable if the ECB was potentially moving toward a less accommodative stance. Benchmark Bund yields doubled within two weeks of Draghi’s speech, and by early July had pushed above 0.5% for the first time since the start of 2016. The euro also jumped, climbing to its highest level against the US dollar for a year.

Speculation about a widespread shift in the monetary policy debate—and there were even some theories put forward about possible co-ordination among central banks—was amplified further by Bank of England (BoE) Governor Mark Carney, who after seeming to suggest UK interest rates should remain unchanged, shortly afterwards referred to the potential for some monetary stimulus to be removed. The United Kingdom has been one of the few G10 economies where inflation has been accelerating, largely due to the fall in the British pound in the wake of the country’s decision in 2016 to leave the European Union (EU). Set against these inflationary pressures have been signs of headwinds affecting the UK economy, principally from the uncertainty around the terms of the United Kingdom’s departure, including data in May showing the slowest annual increase in retail sales for four years.

The combination of higher prices and slower growth has led to conflicting opinions among BoE policymakers on the best way forward. Following a split vote at the BoE’s June meeting, when interest rates were left unchanged, there has been little clear indication of whether more hawkish views might soon represent a majority. Regardless, sentiment in the UK Gilt market shifted abruptly in reaction to Governor Carney’s apparently more hawkish tone, producing a sharp rise in benchmark yields.

In contrast to UK data, economic updates from the eurozone were broadly positive. Consumer confidence across the region hit its highest level in June for 16 years, and in the same month a leading survey of confidence among German businesses climbed to a second consecutive record high. The main PMI for June conveyed a similarly healthy picture, remaining just below record levels and hinting at a further acceleration in growth, with particular strength in manufacturing production.

Following the recent resolution of a failed Spanish lender—the first time the new European system for unified banking supervision had been employed—the Italian government gained approval from the EU authorities for a state rescue of two medium-sized regional banks. The cost of the rescue was estimated at potentially as much as €17 billion, and was seen as controversial in many quarters, since it appeared to go against the new European directive that the costs arising from bank failures would be borne by private creditors rather than taxpayers.

We view the market reaction to ECB President Draghi's remarks as somewhat exaggerated, given that inflation in the region has remained subdued. Even if a formal discussion about scaling back the ECB's monetary stimulus is imminent, such a move seems more likely to take place sometime in 2018, in our assessment. As for the longer-term path for the ECB's monetary policy, a comparison with the Fed's past actions may be instructive. There was a lag of almost two years between the announcement by the Fed of a tapering of its quantitative easing program and the first increase in US interest rates—and an even longer period if measured from the so-called "taper tantrum" of mid-2013. Therefore, we believe the ECB is likely to have a much longer path toward increasing interest rates than currently expected by many market participants, reinforcing our views on the potential for monetary policy divergence between the eurozone and the United States.

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