FIXED INCOME

Global Economic Perspective: December

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Perspective from Franklin Templeton Fixed Income Group

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US Economy's Moderately Strong Growth and Low Inflation Suggest Further Slow-but-Steady Monetary Tightening

We believe the US economy's current combination of moderately strong growth and low inflation is likely to see a further slow-but-steady tightening of monetary policy, following the confirmation by the US Federal Reserve (Fed) at its December meeting of a widely expected interest-rate rise. Regarding a Republican package of tax cuts passed on December 20, at this stage we are cautious about assigning too much significance to such measures' potential impact on economic activity and monetary policy. They could help to keep the US economy's growth rate above its long-term trend during 2018, depending on the speed of implementation. Nevertheless, we think the possible effects beyond a short-term boost are likely to be somewhat limited in terms of magnitude and scope.

Widespread Global Economic Upturn, but Still Little Sign of Inflationary Pressures

The pattern of a strong cyclical upturn in the global economy combined with subdued inflation looks set to continue for some time, in our view. Nevertheless, we believe increasing demand and a diminishing pool of labor are likely to create meaningful pricing pressures at some point. With the influence of factors like demographics and disruptive technological change on economic fundamentals not yet fully understood, it is difficult to predict the catalysts for such a shift to occur. Central banks have also struggled to understand the economic forces at play. Consequently, they seemingly remain inclined to run the risk of falling behind the inflationary curve rather than getting ahead of it. Given the momentum of the global economy, and with interest rates in many countries still not far from their historic lows, we think the risks for both inflation and interest rates look tilted to the upside.

Eurozone Set to Maintain Robust Growth, Supported by Global Economy and ECB Policy

We believe the current robust economic conditions in the eurozone are likely to continue, with a number of factors providing the basis for further expansion. The global economic environment is supportive, and monetary policy looks set to add further to domestic activity, with the European Central Bank (ECB) seemingly awaiting signs that inflation is beginning to move closer to its target of around 2% before moving to a less accommodative stance. Even the region's politics appeared more cohesive than they have for some time, with the strength of the German economy to some extent dampening the uncertainty over the formation of the country's next government.

US Economy's Moderately Strong Growth and Low Inflation Suggest Further Slow-but-Steady Monetary Tightening

We believe the US economy's current combination of moderately strong growth and low inflation is likely to see a further slow-but-steady tightening of monetary policy, following the confirmation by the Fed at its December meeting of a widely expected interest-rate rise. Regarding a Republican package of tax cuts passed on December 20, at this stage we are cautious about assigning too much significance to such measures' potential impact on economic activity and monetary policy. They could help to keep the US economy's growth rate above its long-term trend during 2018, depending on the speed of implementation. Nevertheless, we think the possible effects beyond a short-term boost are likely to be somewhat limited in terms of magnitude and scope.

As expected, the Fed raised interest rates at its December meeting, but for the first time in more than a year, two members of the rate-setting committee dissented, in favor of leaving monetary policy on hold. Policymakers maintained their prediction of three rate hikes in 2018, despite increasing their forecast for growth in the coming year from 2.1% to 2.5%, and lowering the predicted unemployment rate at the end of 2018 from 4.1% to 3.9%. Longer-term growth and inflation estimates were left largely unchanged.

It was unclear if one reason for the Fed's higher growth forecast for 2018 was to take account of a potential fiscal stimulus. President Donald Trump's goal of overhauling the existing US tax code received a significant boost at the start of December, when Republicans in the US Senate gained approval for their plans. The main feature was a sharp reduction in the corporate tax rate, combined with much smaller reductions for individuals. The overall package is estimated to potentially increase the federal deficit by at least US$1 trillion over the next decade. Once the bill had passed, Republican leaders immediately began attempts to reconcile differences between the Senate's plans and an alternate version put forward by their colleagues in the House of Representatives. Both chambers subsequently passed a final tax bill that sets the corporate tax rate at 21%, down from 35%, and the highest individual tax rate at 37%, down from 39.6%.

Data generally continued to portray a positive backdrop for the economy, raising hopes gross domestic product (GDP) could post its strongest run of quarterly growth in more than a decade. Some monthly readings for November pulled back a little from previously elevated levels, but still pointed to a healthy rate of expansion. Examples included purchasing managers' indexes (PMIs) from the Institute for Supply Management (ISM). The headline ISM composite indexes for both manufacturing and services remained upbeat (though down from October's levels), with new orders and business activity particularly strong subcomponents of the respective surveys. Similarly, auto sales showed solid gains in November—registering the third-highest monthly total of the year to date—although this represented a drop from the outsized, hurricane-related gains of previous months.

November's employment report provided further evidence of the economy's robust momentum over the final part of the year. Payrolls expanded by 228,000, ahead of consensus expectations, to leave 2017's average monthly jobs gain at 174,000, not far off the 187,000 pace seen in 2016. Though the unemployment rate was unchanged from its 17-year low of 4.1%, some estimates suggested payroll gains of 100,000 or more could be sufficient to produce reductions in the jobless rate in coming months. There was, however, little sign the diminishing slack in the labor market was stoking wage growth. Average hourly earnings were 2.5% higher than a year earlier, less than consensus predictions, while the equivalent figures for October were revised down.

After a run of weak inflation reports stretching back several months, there was a slight uptick in the October reading of the Fed's favored inflation measure, the core personal consumption expenditures price index. The monthly rate came in as expected at 0.2%, and September's figure was revised up a tenth to the same level, leaving October's year-on-year increase of 1.4% unchanged from the previous month. Inflation measures for November were mixed, with a broad increase in producer prices but a moderation in the annual increase in the core Consumer Price Index, which fell a tenth to 1.7%.

In a market trend likely related to what outgoing Fed Chair Janet Yellen has described as a mysterious lack of inflation so far in 2017, the flattening of the Treasury market yield curve continued. The difference between short- and long-term US Treasury yields dropped below 1% for the first time in a decade. Though the US yield curve remained some way from inversion—which historically is often cited as signaling an impending recession—investors were relatively sanguine about the significance of its flattening, with many arguing that low long-term yields were more reflective of central-bank policies and the weak inflationary environment than dimmer economic prospects.

Widespread Global Economic Upturn, but Still Little Sign of Inflationary Pressures

The prospect that financial services could be caught up in the disruptive innovation that has shaken up many other industries moved a step closer after the Australian Securities Exchange (ASX) announced it would start to use blockchain technology in its equities clearing and settlement systems. Blockchain systems use a public database distributed among multiple computer servers to continuously maintain and verify an electronic ledger of transactions. Apart from offering potential cost savings, the adoption of distributed ledger technology could start to threaten financial institutions by effectively removing the need for conventional, regulated payment systems. It is also used in the settlement of cryptocurrencies such as bitcoin, whose value recently has soared to record levels amid frenzied speculation. While distancing itself from such unregulated payment instruments, the Reserve Bank of Australia revealed it was examining the case for an electronic form of banknotes.

In the first such move by a major Asian economy since 2014, an increase in interest rates by South Korea underlined the breadth of the global economy's upturn in 2017. The decision by the Bank of Korea marked a significant shift from its previous five years of monetary easing. The rate hike—to 1.5% from a record low of 1.25%—was widely expected after data for the third quarter revealed the South Korean economy had recorded its fastest growth in seven years, powered by strong overseas demand for its products. Similar demand was evident in Chinese trade data for November, with exports rising more than 12% year-on-year, well above consensus forecasts. During the month, three of the four main PMIs covering China's manufacturing and services sectors moved higher, suggesting improved business conditions.

Oil producers have also benefited from the global upswing, as stronger economic growth has spurred demand for energy. The other element that has boosted oil prices has been reduced supply. At the latest meeting of OPEC (Organization of the Petroleum Exporting Countries) members and the other major producers, an agreement was reached to maintain current curbs on supply until the end of 2018. However, the inclusion of an option to review the deal in June of next year underlined the continuing dilemma for these producers—how to maintain relatively high prices without stimulating US shale oil production too much. After climbing on news of the agreement, the price of the Brent crude benchmark rose further following a pipeline shutdown, moving above US$65 per barrel for the first time since mid-2015.

Japanese data suggested the country’s exporters were also seeing the effects of the robust global recovery. Third-quarter GDP figures were revised up to show annualized growth of 2.5%, broadly the same pace as seen in the previous quarter. The expansion consisted mainly of exports and corporate investment, with domestic demand estimated to have made up less than half of the total. Inflation has shown little sign of picking up, despite unemployment being at its lowest level in a decade. Some references by Bank of Japan (BOJ) Governor Haruhiko Kuroda to the potentially detrimental effects of negative interest rates led to speculation about a possible adjustment to monetary strategy in 2018. However, the BOJ head swiftly moved to emphasize policymakers’ commitment to the current extremely accommodative policies in order to achieve the central bank’s 2% inflation target.

The pattern of a strong cyclical upturn in the global economy combined with subdued inflation looks set to continue for some time, in our view. Nevertheless, we believe increasing demand and a diminishing pool of labor are likely to create meaningful pricing pressures at some point. With the influence of factors like demographics and disruptive technological change on economic fundamentals not yet fully understood, it is difficult to predict the catalysts for such a shift to occur. Central banks have also struggled to understand the economic forces at play. Consequently, they seemingly remain inclined to run the risk of falling behind the inflationary curve rather than getting ahead of it. Given the momentum of the global economy, and with interest rates in many countries still not far from their historic lows, we think the risks for both inflation and interest rates look tilted to the upside.

Eurozone Set to Maintain Robust Growth, Supported by Global Economy and ECB Policy

Regional economic data in the eurozone remained positive, indicating robust growth underpinned by solid domestic consumption and export demand. In November, measures for employment and new manufacturing orders within a leading business survey reached their highest levels in 17 years, while the composite index itself hit a six-year peak. The strong contribution of the German manufacturing sector was illustrated by its second-highest reading in more than two decades. Other evidence included a European Commission survey of economic sentiment among eurozone businesses and consumers, which climbed to its highest level since 2000, and a measure of French business confidence, which registered a 10-year high.

However, November’s inflation report contained little to persuade the ECB to change course from its relatively loose monetary stance. Annual headline inflation did tick up 0.1% to 1.5%, but core inflation was unchanged at 0.9%, a long way short of the central bank’s target of around 2%. There was better news on unemployment, with the region’s jobless rate dropping further in October to 8.8%. The ECB’s latest set of macroeconomic projections reflected the economic backdrop, containing increased forecasts for growth in the next two years but a relatively small predicted uptick in inflation in 2018, and further out a headline rate of only 1.7% by 2020.

Helped by the eurozone’s strong expansion, particularly in Germany, data showed central Europe had grown at its fastest rate in nine years in the third quarter. Over the period, Poland and the Czech Republic posted around 5% growth year-on-year, while Romania’s economy—with domestic consumption boosted by higher government salaries and pension payments—grew by more than 8%. In August, the Czech central bank started to raise interest rates—the first one within the European Union (EU) to do so since the end of the eurozone’s debt crisis.

In Germany, after many weeks of negotiations, Chancellor Angela Merkel's attempts to form a coalition with the Free Democratic Party and the Greens collapsed in late November. But it still seemed probable she would manage to put together a new coalition, not least because of a widespread lack of enthusiasm for another election so soon after September's vote. Martin Schulz, the leader of the Social Democrat Party (SPD)—which was part of Chancellor Merkel's coalition in the previous government—had previously ruled out another partnership, but at the start of December decided to enter talks. However, the SPD seemed likely to demand a relatively high political price for its continued participation in the government.

After much difficulty, particularly on the question of future arrangements for the Irish border, the United Kingdom (UK) and the EU reached a preliminary agreement in early December, which appeared to allow negotiations on the terms of the UK's departure from the EU to advance further. Though the agreement skirted many of the more intractable differences between the two parties, it did at least avert an early breakdown of talks, which would probably have increased the possibility of a "hard Brexit," whereby the UK would leave the EU in early 2019 without any agreement in place.

We believe the current robust economic conditions in the eurozone are likely to continue, with a number of factors providing the basis for further expansion. The global economic environment is supportive, and monetary policy looks set to add further to domestic activity, with the ECB seemingly awaiting signs that inflation is beginning to move closer to its target of around 2% before moving to a less accommodative stance. Even the region's politics appeared more cohesive than they have for some time, now that the French and German elections have taken place, with the strength of the German economy to some extent dampening the uncertainty over the formation of the country's next government.

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