FIXED INCOME

Global Economic Perspective: February

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Perspective from Franklin Templeton Fixed Income Group

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Volatility Returns to Financial Markets, but US Economic Fundamentals Remain Solid

The opening months of 2018 have seen volatility return to global financial markets, but we think it is important to stress US economic fundamentals have remained broadly the same. After an unusually long period of calm in many markets, the reappearance of volatility at some point seemed likely, even if the speed of market gyrations has been unsettling for investors. We see this year's rise in US Treasury yields as a healthy development, since for some time long-term interest rates have appeared too low, relative to the strength of activity in the US economy and globally. We also believe the outlook for the US economy remains constructive, with little evidence of overheating as yet. However, any extended bouts of market volatility may represent an additional factor for the US Federal Reserve (Fed) to take into account, as it decides how quickly to further tighten monetary policy.

Stronger Global Economy Changes Market Sentiment on Inflation and Interest Rates

It is difficult to assess when corrections in financial markets become sufficiently extreme to begin affecting economic activity. But at this point we do not foresee any significant impact on the global economy from the recent market turbulence. We view it instead as a healthy tempering of excessive optimism among equity investors. Just as the likely consequences of the cyclical upturn in global growth—a gradual return to more normal levels of inflation and interest rates—had, to some extent, been overlooked in market pricing, they now risk being exaggerated. Assuming the effects of the market volatility, on both the confidence of consumers and the assuredness of central bank policies, are relatively muted, the shift in financial markets to levels that better reflect the state of the global economy appears to us to be a welcome development.

Eurozone's Subdued Inflation Likely More Important than Robust Growth in ECB's Calculations

Growth indicators in the eurozone continued to indicate a robust pace of expansion, though there has been little sign of inflation emerging, as the strength of the euro has shielded the region from higher energy costs. The strength of economic activity has boosted speculation that the European Central Bank (ECB) will float a change in monetary policy at its next meeting in March, with some hawks urging the adoption of a less accommodative approach. We think such an announcement is more likely later in the year, as ECB President Mario Draghi could be reluctant to reduce his options so soon, given the region's still subdued inflationary pressures, as well as the unpredictable outcome of the Brexit negotiations.

Volatility Returns to Financial Markets, but US Economic Fundamentals Remain Solid

The opening months of 2018 have seen volatility return to global financial markets, but we think it is important to stress US economic fundamentals have remained broadly the same. After an unusually long period of calm in many markets, the reappearance of volatility at some point seemed likely, even if the speed of market gyrations has been unsettling for investors. We see this year's rise in US Treasury yields as a healthy development since for some time long-term interest rates have appeared too low, relative to the strength of activity in the US economy and globally.

We also believe the outlook for the US economy remains constructive, with little evidence of overheating as yet. Recent data have generally supported the positive domestic backdrop, and many growth forecasts have moved up to reflect the potential effects of the recent package of tax cuts. However, any extended bouts of market volatility—and the possible dampening effects on consumer sentiment—may represent an additional factor for the Fed to take into account, as it decides how quickly to further tighten monetary policy.

The start of the year saw persistent selling pressure in the Treasury market, so that by early February benchmark yields had risen to their highest level in four years. Over the same time, the Treasury yield curve steepened sharply, unwinding some of the flattening that occurred during much of 2017. Various factors were said to be driving the change in sentiment, including expectations the recently passed package of US tax cuts could boost growth and inflation, as well as weigh on the budget deficit, potentially prompting the Fed to step up the pace of monetary tightening. Yields ticked up after consumer price data for December 2017 showed the quickest monthly rate of inflation in a year, once more volatile items like food and energy had been stripped out. Investors were also sensitive to speculation about changes in the policies of overseas central banks, with rumors of a scaling back of quantitative easing by the Bank of Japan and a reduction in Treasury purchases by China adding to the market uncertainty, despite denials from Japanese and Chinese officials.

The first US nonfarm payroll report of 2018 provided grounds for a further jump in Treasury yields, as wages showed signs of picking up. January's 2.9% annual increase in average hourly earnings was the fastest pace seen in nearly a decade, while the reading for the previous month was revised higher, to 2.7%. The acceleration partly reflected a downward adjustment to historical data, while the introduction of higher minimum wages across many states at the start of 2018 may also have boosted the reading. Other elements of the January report pointed to an economy close to full employment, as 200,000 jobs were added—leaving the three-month average gain at 192,000—and the unemployment rate held at 4.1%.

Other data mostly underlined the robust economic environment. January's non-manufacturing purchasing managers' index (PMI) from the Institute for Supply Management indicated continued momentum from the end of 2017, with measures of new orders and employment particularly strong. The equivalent PMI covering manufacturing conveyed a similar picture, although this report suggested potential staffing constraints as well as sharply higher input costs. Though annualized gross domestic product (GDP) growth for the final quarter of 2017 came in shy of consensus estimates at 2.6%, the accompanying rise of 3.8% in consumer spending was the fastest rate since mid-2016. Inventories and trade weighed on the overall GDP calculation. Meanwhile, the core personal consumption expenditures price index—the Fed's preferred measure of inflation—remained subdued in December, at an annual rate of 1.5%.

At the Fed's January meeting—the last chaired by Janet Yellen before handing it over to her successor, Jay Powell—policymakers raised their near-term outlook for inflation, while adding further emphasis to predictions of a gradual tightening of monetary policy against the backdrop of stronger growth. For much of the period, many market participants remained convinced interest rates were set to rise at the Fed's next meeting in March, for the sixth time since late 2015. At one point, predictions for the federal funds rate moved to price in four interest-rate hikes for the current year, ahead of the Fed's own projections of three such increases.

At the start of February, however, increasingly precipitous falls in equity markets led to expectations for future rate hikes being dialed down somewhat. US stocks had enjoyed a strong run since reductions to corporate taxes were passed in December 2017, and many indexes had climbed to record highs as 2018 got underway, despite the backdrop of rising Treasury yields. In the aftermath of the strong wage growth seen in the January's labor market report, sentiment reversed dramatically, generating extreme market volatility. The Standard & Poor's 500 Index saw its largest one-day percentage fall since 2011. Though a majority of market participants still anticipated a rate rise in March, the upsurge in volatility was generally seen as decreasing the chances of a shift by the Fed to a more hawkish stance.

Stronger Global Economy Changes Market Sentiment on Inflation and Interest Rates

The International Monetary Fund (IMF) became the latest institution to acclaim a synchronized increase in global economic growth, raising its forecasts for 2018 and 2019 by 0.2%, to 3.9% for both years. The relatively unusual nature of the current expansion was underlined by data for 2017, revealing it was the first year that all of the G20 economies had expanded since 2010. The reports suggested that of the larger countries, only the United Kingdom and Brazil were losing momentum. The IMF forecasts contained notable increases from its previous set of projections for the United States, Germany and Japan, and specifically referenced an expected boost to the US economy and its trading partners from the recent changes to US tax policy, the potential effects of which accounted for around half of the IMF's upgrade to global growth forecasts.

The decline in the US dollar that was prevalent for much of last year gathered pace as 2018 began. By late January, the US currency had fallen to its lowest level against other major currencies since late 2014, giving back about half of the gains made in the years since the Fed began to tighten its monetary stance. The latest dip was exacerbated by comments from US Treasury Secretary Steven Mnuchin, though the traditional message of support for a strong currency was later reiterated by the Treasury Secretary and President Donald Trump.

As the US dollar's decline continued, at the start of February the Chinese renminbi touched its highest level against the US currency since the renminbi was devalued in mid-2015. Movements in the Chinese currency are heavily influenced by the country's central bank, which since November of last year has adopted a more restrained level of intervention in foreign-exchange markets than during earlier bouts of dollar weakness, when the renminbi's rise was restricted. The recent shift in policy increased speculation that the Chinese authorities were keen to avoid potential accusations of currency manipulation from the Trump administration, which could lead to friction on trade.

After a strong start to the year, in part due to the weakness of the US dollar, commodities were caught up in the heightened volatility affecting equity markets. Brent crude, the international benchmark for oil prices, rose to $71 per barrel at the end of January—pushing its gains since June 2017 to around 60%—but then unwound all of 2018's rise within a week, falling around 6% in a single day. Familiar concerns about rising supplies from US shale oil producers resurfaced amid the turnaround in sentiment.

It is difficult to assess when corrections in financial markets become sufficiently extreme to begin affecting economic activity. But at this point we do not foresee any significant impact on the global economy from the recent market turbulence. We view it instead as a healthy tempering of excessive optimism among equity investors. Just as market pricing previously had appeared to overlook the likely consequences of the cyclical upturn in global growth—namely a gradual return to more normal levels of inflation and interest rates—they now risk being exaggerated. Assuming the effects of the market volatility on both consumer confidence and central bank policies are relatively muted, the emergence of a more realistic assessment of the global economy by financial markets appears to us to be a welcome development.

Eurozone's Subdued Inflation Likely More Important than Robust Growth in ECB's Calculations

Growth indicators in the eurozone continued to indicate a pace of expansion more or less at the maximum potential rate for the region. GDP figures for the fourth quarter of 2017 showed growth of 0.6% from the previous quarter, meaning the eurozone economy expanded by 2.7% over 2017 as a whole, its best performance in many years. The final reading of a leading PMI for January registered its highest level since 2006, with the rate of growth in the manufacturing sector outpacing that of service industries. The report also contained signs of rising pricing pressures, both in terms of input costs and output charges, as well as robust job creation, as the employment subindex matched a recent 17-year high. But the official measure of inflation in the region showed few signs of picking up in January, with annual increases of 1.3% at the headline level and 1.0% for the core measure.

The ECB had already flagged a softening of inflation at the start of 2018, mainly due to a previous rebound in energy prices disappearing from annual calculations. Another factor that has restrained prices in the region has been the rise in the euro, which has appreciated significantly since April 2017 as the eurozone economy has recovered. The euro continued to climb in January, posting a three-year high against a weak US dollar at the end of the month, though it later gave up some of its gains as the US currency rallied from its lowest point amid the heightened market volatility. Prior to the dollar's slight recovery, ECB President Mario Draghi made a point of publicly reminding policymakers from other leading economies of promises made late last year, when they collectively agreed to refrain from talking down their currencies to boost exports.

Spain passed a significant milestone in its recovery from the twin effects of the global financial and eurozone debt crises, when it rejoined the ranks of countries with A rated sovereign debt, after credit-rating agency Fitch upgraded its debt from BBB+ to an A- rating. The upgrade came as the Spanish economy maintained its strong trajectory, seemingly little affected by the uncertainty surrounding the political status of the region of Catalonia. Fitch also highlighted positive trends in the country's levels of public- and private-sector debt, and predicted the budget deficit would fall to 2% of GDP by 2019, down from over 3% in 2017. Soon after the upgrade, the spread between benchmark Spanish and German bond yields declined to its narrowest level since 2010.

In further signs of investors' appetite for higher-yielding eurozone sovereign debt, Greece launched its second bond issue since its 2015 bailout. Additionally, the spread for benchmark Italian yields over German Bunds shrank to its smallest level in over a year, despite the uncertain outcome of Italian parliamentary elections scheduled for March. None of the Italian political parties has appeared likely to win enough support to form a government on their own, leaving the most likely result a stalemate, possibly leading to a center-right coalition. Since both of the main populist parties have toned down their anti-European Union rhetoric, the main risk from any new administration may be a more expansionary fiscal policy. Elsewhere, Germany's wait for a new government seemed almost at an end, after Chancellor Angela Merkel's center-right sister parties reached agreement on a coalition with the Social Democratic Party.

At the ECB's January meeting, while acknowledging the stronger-than-expected growth in the region, policymakers reiterated their commitment to keep the central bank's bond-purchasing program going until inflation starts to rise. Its monthly expenditure of €30 billion on bonds is scheduled to continue until at least September, though there has been speculation that the bank will float a change in monetary policy at its next meeting in March. We think such an announcement is more likely later in the year, as ECB President Draghi could be reluctant to reduce his options so soon, given the region's still subdued inflationary pressures, as well as the unpredictable outcome of the Brexit negotiations.

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