FIXED INCOME

Global Economic Perspective: April

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Perspective from Franklin Templeton Fixed Income Group

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US Economy and Fed Likely to Remain on Current Course Despite Trade Rhetoric

Despite the recent rise in trade tensions, the US economy's solid pace of expansion is likely to remain intact, in our view. We agree with the US Federal Reserve's (Fed's) assessment about a recent pickup in economic activity and believe the domestic environment is supportive of continued momentum over the rest of the year. While there may be a headwind from the uncertainty over trade and related equity market volatility, which could dampen long-term interest rates, at this stage we do not anticipate any impact on the Fed's path of gradually normalizing monetary policy. It remains difficult to judge whether the rhetoric on tariffs will be translated into substantive action that could meaningfully affect economic activity.

Trade Policy Uncertainty Set to Keep Market Volatility Elevated

The extent to which the global economy's upturn is threatened by the uncertainty over trade policy is clearly the main issue preoccupying many investors at this time. Our view is that market sentiment often swings to extremes in these circumstances, running well ahead of actual events, and the risk of a major disruption to global trade remains low. It is even possible the current posturing may result in a positive outcome, for example, by encouraging China to update its policies on intellectual property. The one thing that seems highly probable is the continuation of heightened volatility in financial markets, as investors react to the unfolding developments.

Eurozone Growth Eases Slightly but Still Robust, as ECB Stresses Dovish Outlook

We are not surprised to see signs the eurozone economy is slowing a little, since growth appeared to reach levels that seemed unsustainable a few months back. The European Central Bank's (ECB's) reduction of its bond purchases at the start of 2018 may have been an additional factor in the deceleration. The region's recovery, however, is underpinned by healthy domestic demand, and confidence among consumers and businesses is still strong, which should limit the negative impact of the stronger euro on exports. But with any meaningful rise in inflation still beyond the forecasting horizon of the ECB, we believe the prospects for any rise in interest rates before ECB President Mario Draghi steps down in November 2019 remain slim.

US Economy and Fed Likely to Remain on Current Course Despite Trade Rhetoric

Despite the recent rise in trade tensions, the US economy's solid pace of expansion is likely to remain intact, in our view. We agree with the Fed's assessment about a recent pickup in economic activity and believe the domestic environment is supportive of continued momentum over the rest of the year. While there may be a headwind from the uncertainty over trade and related equity market volatility, which could dampen long-term interest rates, at this stage we do not anticipate any impact on the Fed's path of gradually normalizing monetary policy. It remains difficult to judge whether the rhetoric on tariffs will be translated into substantive action that could meaningfully affect economic activity.

Trade tensions between the United States and China continued to escalate in the wake of the Trump administration's imposition of tariffs on steel and aluminum. The US president unveiled plans to raise US$50 billion of tariffs annually on a wide-ranging list of more than 1,300 products imported from China. He later threatened to add another US$100 billion worth of duties to Chinese imports. He described the moves as retaliation for China's failure to respect the intellectual property rights of US companies over many decades. China responded to the initial tariffs on metals by raising duties on over 100 US imports, mainly relating to agriculture, but toughened its stance after the later US proposals, threatening to add higher-profile products like autos, aircraft, soybeans and chemicals. It seemed likely the agricultural focus of part of China's response was designed to target the output of US states seen as the heartland of President Trump's support. Some US officials were keen to stress that the additional measures were several months away from coming into effect, and it remained unclear how much the two sides might soften their positions over that period. The steel and aluminum tariffs—for which the Trump administration's initial stance that no countries would receive exemptions was later moderated to allow exclusions for most of the largest exporters to the United States—were cited by some commentators as an example of such a compromise. Nevertheless, as the rhetoric from both sides ratcheted up, the uncertainty sparked a fresh bout of volatility in global equity markets.

Data releases over the period were somewhat mixed. February's retail sales declined for the third consecutive month, although there was speculation the replacement of goods—particularly autos—in the wake of the major hurricanes in 2017 might be continuing to distort the data. In addition, tax rebates appeared to be taking longer than previously anticipated to reach individuals. Readings from the Institute for Supply Management's purchasing managers' indexes (PMIs) across manufacturing and services did ease a little in March, but they remained at elevated levels and suggested continued solid expansion. Consensus predictions for first-quarter gross domestic product indicated a slightly slower rate of annualized growth than the upwardly revised 2.9% seen in the final three months of 2017. But with any potential stimulus from the tax cut package yet to become visible in the data, expectations remained high that the economy would maintain its healthy momentum over the rest of the year.

Recently appointed Fed Chair Jay Powell presided over a meeting of the Federal Open Market Committee for the first time in March, and at the subsequent press conference he largely stuck to the same script as his predecessor Janet Yellen. Though the Fed's post-meeting statement added a section highlighting that the economic outlook had strengthened in recent months, he reiterated the aim of gradually normalizing monetary policy, while also pointing out the absence of signs of any imminent acceleration in inflation. The latest set of forecasts from the Fed stirred a little more comment among market participants, particularly the projections for core inflation that were slightly above the central bank's 2% target in 2019 and 2020, which hinted policymakers might be willing to tolerate such an overshoot if they believed longer-term inflationary pressures were limited.

After heightened concerns about inflation early in the year, February's core personal consumption expenditures (PCE) price index and the equivalent reading for the Consumer Price Index (CPI) indicated a steady but still subdued pace, considering the strength of other economic indicators. The annual rate of 1.6% in the core PCE index was its quickest since April 2017—with higher health care prices among the drivers for the second consecutive month, a reversal of the trend seen in recent years. Meanwhile, core CPI held steady at 1.8%.

Hiring came in well below consensus expectations in March's labor market report at 103,000, and revisions subtracted around 50,000 positions from data for the first two months of the year. But after the previous month's outsized gains, there was speculation weather may have affected recent numbers, particularly in construction, as warmer temperatures in February preceded March's poor weather in the Northeast. Wage growth increased, albeit in line with forecasts, as a monthly rise of 0.3% pushed the annual rate up 0.1% to 2.7%. The unemployment rate remained at 4.1% for the sixth consecutive month, although the pace of payroll gains over recent months looked likely to prompt a renewed decline in coming months. The Fed's latest set of projections also anticipated further labor-market tightening, predicting the jobless rate could fall to 3.6% by the fourth quarter of 2019.

Trade Policy Uncertainty Set to Keep Market Volatility Elevated

The latest developments in East Asia saw the North Korean leader Kim Jong Un make his first visit to China, which provides most of the support for his regime, ahead of a planned meeting with President Trump in May. Kim's trip was followed by the announcement of the first summit between North and South Korea in more than a decade, scheduled for the end of April. The leaders of the two Koreas were expected to discuss the denuclearization of the peninsula, following North Korea's acceleration of its nuclear and missile testing program. However, despite Chinese press reports of conciliatory language from Kim, a potential deal that satisfied the North Korean leader's desire to secure the position of his regime, as well as the geopolitical and security interests of China, the United States and its allies, still seemed a long way off.

In Latin America, Brazil's central bank cut interest rates to a record low level of 6.5% to stimulate the country's economy, with a recovery from a deep recession that ended last year still struggling to gain momentum. Historically, Brazil has had some of the highest real interest rates in the world, but benchmark rates have declined by 7.75% since October 2016. Inflation undershot the central bank's target for the first time ever in 2017 and has remained relatively weak. Policymakers signaled another rate cut was likely in the coming months, possibly in an effort to combat any effect from political uncertainty, ahead of the country's presidential elections later this year. In early April, one of the leading candidates, the former President Lula da Silva, lost his appeal to Brazil's supreme court against a sentence for corruption, which seemed almost certain to rule him out of the contest. With Lula polling twice the support of his nearest rival prior to the ruling, the court's decision left the outcome of the elections even more unpredictable.

Positive sentiment in South Africa built further on the momentum gained when Cyril Ramaphosa succeeded Jacob Zuma as president in February. Growth for 2017 came in ahead of government forecasts at 1.3%, with data showing the economy picking up pace during the year. In March, the South African central bank cut interest rates to their lowest point in two years and predicted inflation would stay in its target band of 3%-6% until at least the end of 2020. The country's bonds and currency received another boost when credit-rating agency Moody's said it would keep South Africa at investment grade, thus avoiding a relegation to junk status that would have forced some international investors to relinquish their holdings of South African debt. Moody's cited the significant growth potential of the South African economy, if President Ramaphosa is able to build on his early steps to strengthen the country's institutions.

The extent to which the global economy's upturn is threatened by the uncertainty over trade policy is clearly the main issue preoccupying many investors at this time. Our view is that market sentiment often swings to extremes in these circumstances, running well ahead of actual events, and the risk of a major disruption to global trade remains low. It is even possible the current posturing may result in a positive outcome, for example, by encouraging China to update its policies on intellectual property. The one thing that seems highly probable is the continuation of heightened volatility in financial markets, as investors react to the unfolding developments.

Eurozone Growth Eases Slightly but Still Robust, as ECB Stresses Dovish Outlook

Data in the eurozone suggested growth, while still robust, had pulled back from the elevated levels seen at the start of the year. A leading PMI for the region highlighted slower expansion in the German services sector, but more broadly contained signs of a slight deceleration in new orders, as well as the impact of poor weather on activity in some areas. Nevertheless, the overall picture remained of an economy continuing to expand briskly.

In contrast, inflation remained weak, with the core measure unchanged in March at 1.0% year-on-year, despite a rise of 0.3% in the equivalent headline reading to 1.4%, which appeared mainly due to the effect of Easter on food prices. The data did little to shift the impression the ECB would proceed cautiously when scaling back its accommodative monetary policies. Indeed, toward the end of the month ECB President Draghi reiterated a pledge not to raise interest rates until well after the central bank had ended its quantitative easing program, and then only at a predictable and measured pace. Benchmark German Bund yields ended March at their lowest point since early January.

Hungary's election produced a widely expected victory for Prime Minister Viktor Orban's Fidesz party, its third consecutive success at the polls. The country's strong economy, as well as Prime Minister Orban's tough stance on immigration, appeared to be the main factors that drew support from voters. The government retained its two-thirds parliamentary majority that has allowed it to make changes to the country's constitution, many of which have been criticized by the European Union (EU) for undermining democratic checks and balances. The policies used by Prime Minister Orban have been mirrored by Poland's governing Law and Justice party, underlining the difficulties facing the EU in attempting to ensure all member states abide by its rules, without adding further to populist support.

In France, a critical test of the President Emmanuel Macron's reform agenda loomed, as unions representing a wide range of public sector workers organized protests against his proposals. France's railways appeared to be the key symbolic battleground, since its unions had been at the forefront of mobilizing wider public support to defeat attempts by previous French administrations to reform welfare and pensions. In response to President Macron's planned overhaul of the state-owned rail operator that would end its employees' longstanding special privileges, unions launched a series of strikes on the network scheduled to last several months. The French president's approval ratings have fallen back from their peak following his election last year, and though he commands a sizable majority in the French parliament that allows him to push through legislation virtually unchecked, the confrontation looked likely to provide an important test of public opinion on his attempts to improve the competitiveness of the French economy.

Elsewhere, the United Kingdom (UK) and the EU signed a preliminary agreement on the terms of a transition period for the UK's departure from the EU. The agreement appeared to boost the possibility of an orderly withdrawal process, but many of the most difficult political issues—including the nature of the UK's trading relationship with the EU and of the border arrangements between the Irish Republic and Northern Ireland—remained yet to be decided.

We are not surprised to see signs the eurozone economy is slowing a little, since growth appeared to reach levels that seemed unsustainable a few months back. The ECB's reduction of its bond purchases from €60 billion to €30 billion each month at the start of 2018 may have been an additional factor in the deceleration. The region's recovery, however, is underpinned by strong domestic demand, and confidence among consumers and businesses is still healthy, which should limit the negative impact of the stronger euro on exports. But with any meaningful rise in inflation still beyond the forecasting horizon of the ECB—the central bank estimates price rises of only 1.7% in 2020—we believe the prospects for any rise in interest rates before ECB President Draghi steps down in November 2019 remain slim.

What Are the Risks?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity.