FIXED INCOME

Global Economic Perspective: May

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Perspective from Franklin Templeton Fixed Income Group

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Global Growth Likely to Receive Boost from Increased US Demand
We would broadly agree with the latest assessment of the International Monetary Fund (IMF), which predicted solid global growth over the next two years. A large part of the IMF's more optimistic forecasts was predicated on the potential boost from US tax cuts, and it seems likely increased US demand will be at the forefront of driving expansion around the world. Nevertheless, with other regions like the eurozone and Japan still reliant on their central banks for monetary support, differentials in interest rates between the United States and the other advanced economies could continue to widen.

Eurozone Growth Still Strong, but Lack of Inflation Suggests ECB to Remain Dovish
Despite recent headlines referring to a slowdown in the eurozone, we think it is important to emphasize that the region continues to grow at a rate close to its maximum potential. We believe the current expansion is durable and likely to stabilize at healthy levels, mainly due to the strong domestic demand that has provided its main foundation. However, for the European Central Bank (ECB), inflation remains the primary focus and here recent data have contained little to justify an early exit from the central bank's quantitative easing program. With the ECB's current round of bond purchases set to end in September, policymakers may look to keep their options open for as long as possible before deciding their next move, which could include an extension of purchases into 2019.

US Economy's Expansion Set to Continue and Could Accelerate

The US economy is well placed to continue its expansion, in our view, with an acceleration in growth possible over the rest of the year. Consumer spending appears underpinned by the strong labor market and solid medium-term gains in housing and stocks, and it could pick up after a somewhat subdued first quarter. There are some headwinds, notably the recent rise in energy prices, but these may be offset by the potential stimulus from the package of tax cuts, whose effects could start to become visible later in the year. We are also encouraged by signs the Fed seems willing to look through any temporary rise in inflation, while maintaining its gradual moves toward an appropriate monetary policy setting for the later stages of this economic cycle.

The initial estimate for annualized US gross domestic product (GDP) growth over 2018's first quarter was 2.3%, somewhat slower than the 2.9% expansion seen in the final quarter of 2017. Nevertheless, the data beat consensus forecasts. It also compared well with the more subdued readings at the start of previous years, when unexplained seasonal factors have appeared to dampen growth. The composition of GDP also showed a change from recent trends, with trade and inventories—two of the more volatile components of GDP, which in the last quarter subtracted around 1.7% from growth—both contributing this time around. In contrast, consumer spending rose by only 1.1%, well below consensus forecasts and its smallest rise since 2013. One potential explanation was that the distorting effect of last year's hurricanes on spending patterns, particularly in relation to autos, was continuing to obscure the underlying strength of consumer demand. Nevertheless, some consumer data suggested the quarter ended on a firm note, with March's retail sales growing for the first time since November 2017.

Toward the end of April, benchmark US Treasury yields briefly moved above the highly symbolic 3% threshold, for the first time since 2014. A rise in oil prices to levels last seen nearly four years ago was one of the main factors driving the weakness in Treasuries. Some other global commodity prices also strengthened, pushed higher by uncertainty about US policy on tariffs and sanctions relating to particular metals. Generally, however, with little sign that the Trump administration was moving swiftly to introduce a more comprehensive set of tariffs, a lowering of concerns about an imminent disruption to global economic growth provided further momentum to the selloff in the Treasury market. One notable consequence was a rise in US mortgage rates to their highest point since 2013. The US dollar also strengthened, with April marking some of its strongest gains against other major currencies since the 2016 US presidential election.

Inflation indicators generally continued their modest upward progress, bringing the Fed's target of 2% into view. The March reading of the central bank's favored gauge of pricing pressures, the core personal consumption expenditures price index, increased to 1.9% year-on-year (y/o/y), in line with consensus expectations and a rise of 0.2% from the previous month. However, much of the rise was due to historical effects, reflecting a steep drop in telecoms prices in early 2017.

Ahead of the Fed's meeting at the start of May, several policymakers commented they were comfortable with the prospect that inflation might overshoot the Fed's 2% target, after the rise in energy prices. But the officials also emphasized at this point they believed the rise in inflation was likely to prove temporary, reflecting consensus forecasts that suggested the latest move could be reversed later in the year. The Fed's post-meeting statement was largely as expected, although the term "symmetric" was introduced to describe the central bank's 2% inflation target. Some market participants interpreted its inclusion as aimed at soothing concerns about the potential for an over-reaction in monetary policy in response to higher inflation.

The earnings season provided some anecdotal signs US companies were accelerating their capital expenditure plans, following the recent package of tax cuts. Past the midway point of the quarter's earnings reports, corporations had collectively flagged plans to increase their spending by around a third. There were also some examples of companies attempting to push through price increases, perhaps in response to a tighter labor market and rising input prices. Though the Institute for Supply Management's purchasing managers' index (PMI) for manufacturing declined in March for the second consecutive month, the sub-index for raw materials prices reached its highest level since 2011.

April's labor market report showed a payroll gain of 164,000 that was below consensus expectations, although the miss was broadly offset by an upward revision to the previous month's figures. But there was little sign that the tightness of the labor market was putting pressure on wages. Average hourly earnings were up 0.1% month-on-month and 2.6% y/o/y, both less than consensus forecasts; additionally, the previous month's increases were revised down. As had been widely expected after the strong hiring seen in recent months, the unemployment rate fell further, declining by 0.2% to 3.9%, well below the Fed's latest estimate of the levels sustainable over the longer term. This new cycle low again raised the question of how much further the labor market could tighten before the traditional Phillips curve[1] correlation between inflation and unemployment—the breakdown of which has been one of the most notable features of US economy's recovery in recent years—might re-emerge.

Global Growth Likely to Receive Boost from Increased US Demand

Oil prices continued their long rally from a low point of less than US$30 per barrel at the start of 2016, with the Brent crude oil benchmark reaching US$75 per barrel toward the end of April. A combination of rising demand—as growth has picked up across the global economy—and measures to limit supply has reduced inventory levels close to historical averages. Despite initial skepticism about their durability and effectiveness, cuts in production agreed between Saudi Arabia, other OPEC (the Organization of the Petroleum Exporting Countries) producers and Russia have succeeded in their aim of driving prices higher. With the US government voicing doubts about the international agreement reached with Iran on the country's nuclear industry, the potential re-introduction of US sanctions on Iranian oil exports appeared to be another factor influencing market sentiment. As has been the case before, rising prices have led to an expansion of US shale oil production, although so far this year higher US output has been absorbed by increased demand.

The US dollar's resurgence increased pressure on some emerging-market currencies, most visibly the Argentinian peso and Turkish lira. After the Argentinian currency fell by 8% against the dollar in two days, the country's central bank was forced to repeatedly raise interest rates, pushing its benchmark rate to an extraordinary 40% by early May. The administration of President Mauricio Macri, who has been in power since late 2015, has adopted an incremental approach to reforms, aimed at reducing the country's primary fiscal deficit. But under his administration, Argentina's foreign-currency debts as well as its current account deficit have both increased sharply, adding to nervousness among international investors.

A brief respite in trade tensions appeared to end after the United States presented China with an updated set of demands, including a call for a reduction of US$200 billion—up from the previous figure of US$100 billion—in the US trade deficit with China. China's response was equally uncompromising, but some analysts were quick to re-iterate the Trump administration's tactic of adopting extreme positions at the start of negotiations. The progress of talks between the United States, Canada and Mexico on renegotiating the North American Free Trade Agreement (NAFTA) continued to be closely monitored for potential clues about US negotiating tactics. Here, the start of June looked a key deadline, marking the point when US tariffs on steel and aluminum, which were postponed for NAFTA and European Union (EU) countries, are set to be re-imposed.

The prospect of a left-wing populist politician becoming president in Mexico's July elections seemed to draw closer, after the frontrunner, Andrés Manuel López Obrador, largely deflected criticism from his rivals in the first presidential debate. López Obrador lost the 2006 election when in a similarly strong position, so a late swing in voting intentions remained possible. However, the lessons from mistakes in that campaign and the absence of a second round in Mexico's presidential elections—which removes any requirement to win a majority—argued against such a repeat. The country's economy continued to perform well in the first quarter, with annual growth of 2.4%. (adjusted for the timing of Easter) well ahead of consensus expectations.

In contrast, the Mexican peso showed signs of adjusting for the perceived political risk from a López Obrador victory, weakening to its lowest levels against the US dollar since the start of the year. However, as one of the most liquid emerging-market currencies, the peso is often seen by international investors as a wider proxy. With the rise in US Treasury yields and the US dollar, outflows from emerging-market assets generally have added to pressure on the Mexican currency. Mexico is an example, we believe, of a sovereign issuer for which short-term political uncertainty can obscure positive fundamentals, and temporarily result in market valuations becoming somewhat detached. This previously occurred during the selloff in the peso ahead of the US presidential election and its subsequent rally.

In terms of the global economy, we would broadly agree with the latest assessment of the IMF, which predicted solid global growth over the next two years. A large part of the IMF's more optimistic forecasts was predicated on the potential boost from US tax cuts, and it seems likely increased US demand will be at the forefront of driving expansion around the world. Nevertheless, with other regions like the eurozone and Japan still reliant on their central banks for monetary support, differentials in interest rates between the United States and the other advanced economies could continue to widen.

Eurozone Growth Still Strong, but Lack of Inflation Suggests ECB to Remain Dovish

First-quarter GDP figures for the eurozone confirmed the dip in growth that had been suggested by previous data. Though the rate of growth compared to the previous quarter slowed from 0.7% to 0.4%, the weakest reading since mid-2016, the annual rate of 2.5% was still close to the highest levels seen since the region's debt crisis. Numerous factors seemed likely to have contributed to the deceleration, not least the difficulties of sustaining the lofty levels of growth seen in late 2017 in the face of the eurozone's capacity constraints and other structural impediments. One-off factors, including strikes in France and bad weather, probably also impacted the data. The euro's past strength also appeared to have weighed on demand for the region's exports.

Some early indicators suggested a further cooling of growth in the second quarter, with a closely watched survey of German business sentiment softening in April for the third consecutive month. But stabilization in other measures supported the idea that the weakness in the first quarter was transitory rather than the start of a sustained slowdown. After a sharp drop in March, the European Commission's economy sentiment survey was unchanged in April and remained at a relatively high level. In the same month, a leading PMI covering both manufacturing and services in the region pointed to a level of growth that was still robust, albeit down from its recent peak.

However, the latest inflation figures served as another reminder that the eurozone's recovery has so far failed to produce any meaningful upward pressure on prices. While April's headline rate of annual inflation fell by 0.1% to 1.2%, the core rate showed a much larger decline of 0.3% to 0.7%, although an early Easter holiday period seemed likely to have been at least partly responsible. At the ECB's April meeting, ECB President Mario Draghi said policymakers believed headline inflation would "hover" around 1.5% for the rest of the year, but that underlying inflation remained subdued and lacking any signs of a sustained rise. Only the maintenance of an ample degree of monetary stimulus, he stressed, would allow underlying pricing pressures to build over the medium term.

First-quarter GDP figures for the United Kingdom (UK) showed an increase of only 0.1% from the previous quarter, the slowest rate in five years. Poor weather was responsible for a decline in construction, but elsewhere the data pointed to broad-based weakness across the UK economy. UK consumers have been squeezed by a rise in inflation—resulting from a fall in the British pound after the UK's decision to leave the EU—and anemic wage growth. Across businesses, a number of planned investments seem to have been put on hold, due to the ongoing uncertainty about future trade arrangements. In its latest forecasts, the IMF predicted the UK economy would grow more slowly than all the other major European economies (except Italy's) over the next two years.

Despite recent headlines referring to a slowdown in the eurozone, we think it is important to emphasize that the region continues to grow at a rate close to its maximum potential. The eurozone's unfavorable demographics, as well as its fragmented political and financial systems, render it unable to match the dynamism and growth potential of, for example, the United States. But we believe the current expansion is durable and likely to stabilize at healthy levels, mainly due to the strong domestic demand that has provided its main foundation. However, for the ECB, inflation remains the primary focus and here recent data have contained little to justify an early exit from the central bank's quantitative easing program. With the ECB's current round of bond purchases set to end in September, policymakers may look to keep their options open for as long as possible before deciding their next move, which could include an extension of purchases into 2019.

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1. The Phillips curve describes an inverse relationship between the unemployment rate and inflation.

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