FIXED INCOME

Global Economic Perspective: July

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Perspective from Franklin Templeton Fixed Income Group

In this Issue:

Trade Policies Cloud US Economy’s Positive Growth Prospects

We think the US economy remains in good shape, with the rate of growth potentially picking up, a labor market that is tight but attracting new workers, and inflation that still seems relatively subdued. Boosted by tax cuts and spending increases, these favorable conditions could continue for some time. The US Federal Reserve (Fed) has recently emphasized its upbeat assessment of US growth prospects, keeping it on course to continue slowly tightening monetary policy. But investors should be aware of the growing risks to this scenario further out, in our view. Foremost among these is the uncertainty caused by the Trump administration’s aggressive policies on trade, which—absent an improbable reversal in numerous policy areas—are likely to start to weigh on both US and global economic growth at some point. Indeed, they may have already started to do so.

US Dollar Strength and Trade Uncertainty Adding to Problems for Some Countries

Though the threats to global trade have dominated headlines, many of the more liquid G7[1] markets have maintained an uneasy equilibrium since the end of May. Judging to what extent and how quickly such trade-related concerns could affect the momentum of the global economy remains difficult for investors, but the topic seems certain to dominate agendas over the coming quarters and possibly well beyond. Some of the more extreme scenarios would be highly damaging, but we continue to believe a more rational economic approach is likely to prevail at some point, in order to prevent such outcomes. However, until such views can gain greater political traction in the United States, further outbreaks of market volatility seem inevitable.

ECB Upbeat about Growth Outlook, but Concerns on Trade Increasing

While the eurozone's recovery is still reliant on the European Central Bank's (ECB's) monetary stimulus, its growth appears healthy (relative to potential), domestic demand looks solid and inflation has yet to meaningfully pick up. Nevertheless, if further uncertainty about global trade causes a more negative outlook to take hold among the region's manufacturers, the current rate of expansion in the eurozone could slow. For all the optimism expressed recently by the ECB on the outlook for growth, the flexibility built in to its planned cessation of bond purchases at the end of 2018 could yet prove useful.

Trade Policies Cloud US Economy's Positive Growth Prospects

We think the US economy remains in good shape, with the rate of growth potentially picking up, a labor market that is tight but attracting new workers, and inflation that still seems relatively subdued. Boosted by tax cuts and spending increases, these favorable conditions could continue for some time. The Fed has recently emphasized its upbeat assessment of US growth prospects, keeping it on course to continue slowly tightening monetary policy. But investors should be aware of the growing risks to this scenario further out, in our view. Foremost among these is the uncertainty caused by the Trump administration's aggressive policies on trade, which—absent an improbable reversal in numerous policy areas—is likely to start to weigh on both US and global economic growth at some point. Indeed, they may have already started to do so.

There are already signs that market participants have started to price in the possibility of such a development, most noticeably in the US Treasury market. In terms of the US economy, prolonged uncertainty about trade policy could see more companies put planned investment on hold, dampening the boost to corporate expenditure provided by the recent tax cuts. Although the current positive economic trajectory means corporate earnings are likely to remain strong for a while, the imposition of further tariffs may exacerbate existing shortages of labor and materials, reducing profitability. Ultimately, given the current minimal growth in wages for US workers (after allowing for inflation) and with tariffs likely to increase the cost of many goods, the impact could eventually hinder consumer spending.

While such potential concerns lie ahead, the underlying strongly supportive backdrop for the economy has persisted. Indicators suggested a potential acceleration of economic growth, as consensus estimates for 2018's second quarter fell in the range of 3.5% to 4.5%, significantly higher than the revised annual gross domestic product growth rate of 2.0% in the first quarter. After May's buoyant labor market report, data showed demand for workers remained strong in June. A monthly addition of 213,000 positions beat consensus expectations and was accompanied by upward revisions totaling 37,000 for the two previous months.

The unrelenting pace of job gains did little for wages, however, with annual hourly earnings falling short of consensus forecasts, dipping slightly to 0.2% month-on-month and 2.7% year-on-year (y/o/y). One restraining factor on wages may have been the expansion of the labor force, which grew by around 600,000, as the strong demand from employers encouraged more people to seek work. This new supply of workers pushed the participation rate up by 0.2% to 62.9% and the unemployment rate up by a similar amount to 4.0%.

Nevertheless, as Fed Chair Jay Powell pointed out in a speech at a symposium of central bankers in June, the participation rate remained well below the levels seen before the global financial crisis. It also still lagged the rates of most other advanced economies. The economy appeared close to full employment, he suggested, if judged by measures like the elevated ratio of job vacancies to the numbers of unemployed or the amount of workers leaving their jobs, a sign of confidence in their ability to find a new position. But, in his view, the low growth in wages and productivity cast doubt on whether the labor market was excessively tight.

The Fed chair argued that historical comparisons were of limited use, as the rate of unemployment consistent with low and stable inflation (the so-called “natural” rate) could have fallen since previous economic cycles. This lack of precedent increased uncertainty about the consequences of an extended period of low unemployment, and raised the possibility of complacency about a tipping point in wage inflation. But he also stressed the potential for further benefits, including the continued re-entry into the labor market of previously discouraged workers—for example, among minorities and the disabled—as well as wider gains to productivity and growth.

Broader measures of inflation generally rose modestly, boosted by higher gasoline prices. June’s headline consumer price index climbed by 2.9% y/o/y, its highest reading since 2012, with the equivalent core number up 0.1% to 2.3%. In May, the core personal consumption expenditures (PCE) price index, the Fed’s favored gauge of inflation, reached 2% y/o/y for the first time in six years. But the significance of reaching the central bank’s 2% target was somewhat muted by prior signals from Fed policymakers that they might tolerate an overshoot in price increases.

Indeed, there was little sign of reaction in the US Treasury market to the milestone of the 2% core PCE reading, and benchmark 10-year yields continued to fall back from the 3% threshold over June and into July. Much of the reason for the resilience of Treasuries appeared to be uncertainty among investors stemming from escalating global tensions on trade. With shorter-dated issues more sensitive to expectations of further interest-rate increases, the yield curve continued to flatten, narrowing the difference between two-year and 10-year Treasury yields to its lowest level since 2007.

The Trump administration continued to raise the stakes in its efforts to secure concessions from other countries on trade, imposing tariffs on Chinese imports worth US$34 billion in early July. After China accused the US president of “trade bullying” and retaliated with similar measures, President Trump initiated procedures to widen the tariffs to apply to US$200 billion of goods coming from China, and indicated this could ultimately be extended to the full US$500 billion of Chinese imports. He also showed no sign of pulling back on plans to impose tariffs on more than US$330 billion of imported autos and auto parts—which appeared aimed at gaining leverage in negotiations with the European Union (EU)—citing the same need to defend US manufacturing used to justify the recent imposition of tariffs on steel and aluminum. With the strategic goals of US policy still opaque, how the country’s unilateral escalation of tensions with its major trading partners in the global economy would eventually play out remained an open question.

US Dollar Strength and Trade Uncertainty Adding to Problems for Some Countries

The US dollar strengthened for the third consecutive month in June, posting its best quarterly performance since 2016 over the second quarter as a whole, helped by a combination of tighter US monetary policy and increased risk aversion among investors. After the dollar’s strength had contributed to a wide-ranging selloff of emerging-market assets in May and early June, some of these bonds and currencies staged a partial recovery. One of the best performers was the Mexican peso, which rallied around 10% in the weeks following its mid-June low point, barely affected by the widely expected victory of the left-wing candidate Andrés Manuel López Obrador in the country’s presidential election at the beginning of July. Investors seemed reassured by early commitments to fiscal discipline and central bank autonomy from the incoming Mexican president’s appointee as finance minister.

In contrast, the Turkish lira remained under pressure. After President Recep Tayyip Erdogan’s victory in elections late in June, which granted him a far greater degree of executive powers, a brief rally quickly gave way to renewed selling, as concerns grew about the Turkish president’s increased control over the economy. Such fears appeared justified as President Erdogan quickly gave himself control over appointments at Turkey’s central bank, and later appointed his son-in-law to head a new treasury and finance ministry, sidelining officials seen as supporters of orthodox economic policies. With annualized inflation rising to 15% in June—more than three times the central bank’s official target—and President Erdogan maintaining his views that interest rates needed to be reduced, Turkey’s vicious circle of unchecked inflation, inappropriate monetary policy and a weakening currency appeared a long way from resolution.

In a sign that currency volatility was not confined to structurally weaker countries like Turkey, the Chinese renminbi suffered its largest ever monthly decline against the US dollar in June, having previously held up relatively well in the face of the US currency's strength. The renminbi's fall raised concerns that China might use a devaluation as part of its response to the US imposition of tariffs on some Chinese goods. However, the People's Bank of China moved quickly to refute such speculation, and its message—along with intervention in foreign exchange markets by Chinese state-owned banks—served to steady the Chinese currency.

Some domestic data from the Chinese economy in May were weaker than consensus expectations, particularly industrial output, investment and retail sales, and raised the possibility that the Chinese government's efforts at deleveraging and reform might be starting to soften domestic demand. Previously, official measures to rein in debt have mainly affected financial institutions, but the challenges for policymakers seemed likely to grow far greater if the effects were to spread to the other areas of the economy, like real estate. Property has contributed around a fifth of China's growth in recent years, but for some time the pace of price rises has appeared unsustainable, due to factors including affordability, supply and demand imbalances, and financial stability. The latest data served as a reminder that the threat to China's economy posed by trade tensions was potentially only one of a number of issues for investors to consider.

Among the G7 economies, Canada raised its interest rates for the fourth time in just over a year. The widely expected move came with inflation close to the Bank of Canada's target of 2%, and followed solid employment and wage data. Officials from the country's central bank said they believed the Canadian economy was close to capacity, and cited the stronger-than-expected performance of the US economy as they raised growth forecasts for 2019 and 2020.

Though emerging-market assets have been hard hit, for all the threats to global trade have dominated headlines, many of the more liquid G7 markets have maintained an uneasy equilibrium since the end of May. Judging to what extent and how quickly such trade-related concerns could affect the momentum of the global economy remains difficult for investors, but the topic seems certain to dominate agendas over the coming quarters and possibly well beyond. Some of the more extreme scenarios would be highly damaging, but we continue to believe a more rational economic approach is likely to prevail at some point, in order to prevent such outcomes. However, until such views can gain greater political traction in the United States, further outbreaks of market volatility seem inevitable.

ECB Upbeat about Growth Outlook, but Concerns on Trade Increasing

Apprehension about the prospects for global trade was also evident in Europe. A leading indicator of business sentiment in Germany, one of the world's leading exporters, declined in June after briefly stabilizing in the previous month. In the survey, the outlook of German companies on trade turned slightly pessimistic for the first time since the start of 2015. Trade tensions and higher energy prices were the main reasons given by the European Commission for a reduction of its growth forecast for 2018, from 2.3% to 2.1% for the eurozone as a whole and an even larger cut from 2.3% to 1.9% for Germany.

In minutes released from the ECB's June meeting, policymakers acknowledged that trade tensions between economies had become more likely, but overall the discussions were mainly upbeat, focusing on an outlook for medium-term growth that remained solid and broad-based. ECB President Mario Draghi struck a similarly confident tone in later comments, stressing the importance of the central bank's monetary stimulus in boosting growth and inflation. At its June meeting, the ECB announced a target date of the end of 2018 to cease its bond purchases, though it was widely expected to continue reinvesting the proceeds of the maturing bonds it holds beyond that date. The ECB president also said that strong growth would be likely to largely resolve the problem of bad loans in the region's banking system, a factor seen as preventing a more efficient flow of credit to businesses.

Despite the UK government releasing a paper setting out its proposals on a future relationship, the eventual outcome of the United Kingdom's (UK's) negotiations with the European Union (EU) on the terms of its departure remained unclear. The unveiling of the document—which envisaged relatively close links with the EU continuing in several areas—sparked a number of high-profile resignations by UK government ministers. With Prime Minister Theresa May's leadership once more being called into question, the agitated political backdrop underlined the divisions within the ruling Conservative party, as well as its lack of a parliamentary majority, ahead of future negotiations with the EU.

While the UK's approach is still unresolved and its negotiating position appears weak, the dangers for the remaining EU members of failing to reach an agreement with the UK could be underappreciated, in our view. Notwithstanding the resulting blow to the EU's trade with one of its most important trading partners—it currently has a significant trade surplus with the UK—the relative impact of such an economic shock would be felt in very different ways. The UK's monetary independence would suggest an immediate sharp devaluation in the British pound, whereas any concurrent change in the euro would be applied equally to all the eurozone members, potentially hurting some of the structurally weaker countries. Such strains could increase support in some EU countries for populist parties that have questioned the benefits of continued membership.

The eurozone remains at a far less advanced point of the economic cycle than the United States, and still has significant spare capacity in a number of areas, particularly its labor market. While the region's recovery is still reliant on the ECB's monetary stimulus, its growth appears healthy (relative to potential), domestic demand looks solid and inflation has yet to meaningfully pick up. However, if further uncertainty about global trade causes a more negative outlook to take hold among the region's manufacturers, the current rate of expansion in the eurozone could slow. For all the optimism expressed recently by the ECB on the outlook for growth, the flexibility built in to its planned cessation of bond purchases at the end of 2018 could yet prove useful.

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1. The Group of Seven consists of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

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