Global Economic Perspective: November

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Perspective from Franklin Templeton Fixed Income Group

In This Issue:"

Uncertainty Ahead of Trump Administration but Fundamentals Remain Constructive

Following the outcome of the US elections, the longer-term implications for fixed income markets are still unclear. Given the uncertainty around a Donald Trump presidency, volatility may remain elevated until the way forward becomes more apparent. But to us the fundamentals for the US economy continue to be constructive, underpinned by the backdrop of strength in the labor market and demand from consumers. Though the policies of the new administration may influence some sectors more than others in 2017 and beyond, we believe the passage of the election and the economy's current solid, if somewhat sluggish, expansion should in turn give the US Federal Reserve (Fed) enough confidence to further tighten monetary policy, albeit at a very measured pace.

Divergence in Monetary Policies Between World's Leading Central Banks Likely to Remain Intact

Despite the recent rise in global bond yields, we believe the divergence in monetary policies between the world's leading central banks remains intact—judging the pace and resulting degree of variation of those policies will probably be the critical issue for investors over 2017. However, the pace and policy trajectory for the Bank of Japan (BOJ) are unpredictable, and further complicated by widespread doubts about the credibility of its targets.

Eurozone Bond Yields Rise but ECB Likely to Adjust Rather Than Signal End of Quantitative Easing

Eurozone bond yields recently have risen partly on speculation suggesting an impending shift in monetary policy by the European Central Bank (ECB). In the absence of more supportive economic data, we feel any such assumption is somewhat premature. While an adjustment of the ECB's current quantitative easing program is probable, in order to accommodate structural constraints within eurozone bond markets, we think such measures are more likely to be taken to facilitate further monetary easing beyond the impending deadline, rather than risk the potentially detrimental tightening effects of any perceived tapering of monetary stimulus.

Uncertainty Ahead of Trump Administration but Fundamentals Remain Constructive

Following the outcome of the US elections, the longer-term implications for fixed income markets are still unclear. Given the uncertainty around a Trump presidency, volatility may remain elevated for some time until the way forward becomes more apparent. But to us the fundamentals for the US economy continue to be constructive, underpinned by the backdrop of strength in the labor market and demand from consumers. Though the policies of the new administration may influence some sectors more than others in 2017 and beyond, we believe the passage of the election and the economy's current solid, if somewhat sluggish, expansion should in turn give the Fed enough confidence to further tighten monetary policy, albeit at a very measured pace.

The Fed had been widely expected to refrain from making any changes to monetary policy at its November meeting, given the meeting's proximity to the US presidential election, and these expectations proved correct. However, the central bank tweaked the language in its accompanying statement to indicate an increase in benchmark interest rates was moving closer, and in doing so bolstered existing forecasts that a hike at its next meeting in December was the most likely next step. For much of October, US Treasury yields rose and the Treasury yield curve steepened, though this move tracked a trend seen across government bond markets globally, which was largely caused by speculation other leading central banks might rein in their quantitative easing programs at some point in 2017.

The Fed's stance reflected the solid economic data seen since its last meeting, most notably third-quarter gross domestic product (GDP) figures, which underlined the steady overall performance of the US economy since the middle of the year. While the higher-than-expected annualized growth of 2.9% was the fastest rate in two years, the headline number masked some significant swings within its more volatile underlying components, particularly a surge in exports that was largely due to unusually strong overseas demand for soya beans. Inventories, which had been a drag on growth, also made a positive contribution, as did government spending, but conversely consumer spending, the main driver of the economy in previous quarters, slowed from its elevated second-quarter pace of 4.3% annualized growth to a more sedate 2.1% increase.

The standout feature of the labor market report covering October was an acceleration of wage growth to 2.8% year-on-year (y/y), its fastest rate since 2009. The solid nature of the rest of the report also lent broad support to a Fed move to raise US interest rates before the end of the year, with 161,000 jobs added during the month and an upward revision of 44,000 to the previous two months' job totals. The unemployment rate dipped by 0.1% to 4.9%, but the labor force participation rate also dropped by the same amount to 62.8%.

Inflation data ticked up at the headline level, as the impact of a fall in oil prices from mid-2014 onward waned. In September, the personal consumption expenditures (PCE) price index hit 1.2% y/y, its highest level since November 2014. But the Fed's favored inflation measure, core PCE, was unchanged at 1.7% for the same period, staying within the tight range of between 1.6% and 1.7% seen since the beginning of the year, even if the readings have moved somewhat higher compared with the 1.4% average seen in 2015. The pattern of rising headline but subdued core inflationary pressures was mirrored in September's Consumer Price Indexes, as the annual headline rate jumped from 1.1% to 1.5% but the core rate actually moved down 0.1% to 2.2%.

The Institute for Supply Management's purchasing managers' index (PMI) for manufacturing suggested overall stability, with October's reading coming in a touch higher than the previous month's data. There were some indications of future headwinds, as readings for the sub-components of the index covering new and unfulfilled orders softened, but this was partially offset by a small strengthening in new export orders. The equivalent PMI for services came in at 54.8, well above the 50 mark that divides expansion and contraction, though lower than its extremely strong showing in the previous month. This pattern was repeated in many of the sub-components of the index, with employment, new orders and business activity all pointing to solid growth, but down from their previous elevated readings.

Though the unexpected outcome of the US elections may persuade the Fed to delay any rate hike before the end of the year due to market volatility, we do not believe a Trump presidency will materially alter the course of the US economy in the near term. Fundamentals ultimately drive longer-term performance in the fixed income markets, and in our view, these remain broadly supportive of a slow but steady rate of expansion.

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The US dollar strengthened for much of October—moving up, on a trade-weighted basis, close to the highs seen at the start of 2016—before pre-election uncertainty trimmed some of its gains. As well as hitting its strongest level against the euro for several months, the dollar also posted a six-year high against the Chinese renminbi. However, the latter move was seen as principally driven by dollar strength rather than renminbi weakness, and therefore had little impact on market sentiment, unlike recent episodes of renminbi depreciation.

Data showed the Chinese economy expanded at an annual rate of 6.7% in the third quarter, similar to the two previous quarters and in line with the Chinese government's full-year target. Official and private PMIs for the Chinese economy were strong in October, with the official manufacturing index rising to its highest point since July 2014, underlining the helpful effects of the weak renminbi.

The gains in oil prices in the wake of a surprise draft agreement in late September among members of the Organization of the Petroleum Exporting Countries (OPEC) to lower production proved temporary. After the benchmark for Brent crude reached its highest level of the year in mid-October, growing doubts about the enforceability of the agreement along with rising US oil inventories saw benchmark prices fall back to well below the US$50 per barrel mark.

The latest illustration of the BOJ's inability to re-introduce inflation into the Japanese economy came at its October meeting, as it pushed back the date for meeting its 2% inflation target to the fiscal year starting in 2018. In September, annual inflation in Japan excluding energy and food prices fell to zero, the lowest level since the existing monetary easing program began, while the equivalent headline number contracted by 0.5%.

When BOJ Governor Haruhiko Kuroda announced the start of the central bank's current monetary easing program back in 2013, he predicted the target would be achieved within two years. But as the most recent delay of the inflation target by the BOJ was not accompanied by any new monetary policy measures, many market participants concluded policymakers would now be inclined to hold off any further major adjustments for a while. It seemed more likely the BOJ would try to evaluate whether its policy of negative interest rates, as well as the more recently announced targeting of a zero ceiling for benchmark government bond yields, was feeding through to the economy.

Despite the recent rise in global bond yields, we believe the divergence in monetary policies between the world's leading central banks remains intact—judging the pace and resulting degree of variation of those policies will probably be the critical issue for investors over 2017. While we think the Fed will move at a slow but steady pace, the pace and policy trajectory for the BOJ are far more unpredictable, and further complicated by widespread doubts about the credibility of its targets.

Eurozone Bond Yields Rise but ECB Likely to Adjust Rather Than Signal End of Quantitative Easing

Third-quarter GDP figures for the eurozone indicated growth in the region remained steady but subdued, rising 0.3% quarter-on-quarter and 1.6% y/y. The region's figures were helped by a slightly better performance from the French economy, which returned to growth after contracting in the previous three months, and another robust showing from the Spanish economy. In a similar pattern to that seen in the United States, the eurozone's annual headline inflation reached a two-year high of 0.5% in October as the impact of lower energy prices diminished, but core inflation was unchanged, rising 0.8% from a year earlier. Other data suggested the region's economy had started the fourth quarter on a positive note, with surveys measuring economic sentiment and among purchasing managers reaching their highest levels of the year.

Eurozone bond yields moved steadily higher for much of October, following a report the ECB might look to scale down its quantitative easing program, though this was quickly denied by the central bank. Investors began to re-evaluate the prices they were willing to pay for bonds across the region, many of which started the month close to recent record highs—levels attained on fears about the United Kingdom's vote to leave the European Union (EU) and the boost to the market provided by the ECB's purchases. Wariness about a potential inflection point in deflationary pressures (and therefore the extent of the ECB's quantitative easing) kept sentiment among investors weak, notwithstanding the dearth of persuasive data to prompt such a major policy shift by the central bank. Ironically, October's rise in yields helped to increase the amount of eligible bonds available to the ECB, which is limited to buying issues yielding more than its -0.4% deposit rate. The prevalence of negative-yielding debt across many eurozone markets had been seen as one of the key impediments to the central bank's purchasing program continuing in its current form.

One of the biggest upward moves in global government bond yields during October occurred in UK Gilts, as the better-than-expected performance of the UK economy and a jump in inflation due to the weakness of the British pound cast doubts on any potential further easing of UK monetary policy. The Bank of England sharply increased its inflation forecasts, estimating a peak of 2.8% in early 2018 as the effects of currency depreciation continued, though it intimated it would tolerate a temporary overshoot of its 2% target. The central bank also cautioned against excessive confidence based on currently robust data, which it believed could be offset in the event of a so-called "hard Brexit," whereby the United Kingdom lost access to the EU's single market. The prospects of such an outcome were, however, called into question after a legal ruling that threatened the UK government's ability to negotiate an exit deal without first securing parliamentary approval for its approach.

The political stalemate in Spain was finally broken when Mariano Rajoy, the leader of the conservative Partido Popular (PP), was elected as prime minister at the head of a minority government. The compromise—which allowed an administration to be formed for the first time in 10 months—occurred after the opposition Socialist party opted to abstain in the parliamentary vote to elect the PP leader, having failed in its own attempts earlier in the year to build a governing coalition.

Spain's political gridlock has been largely ignored by investors, and yields on Spanish government bonds have tumbled during the year, with the benchmark 10-year yield reaching a record low at the end of September. Even though Spanish sovereign bonds experienced a sharp snapback in October amid the rise in global yields, they still outperformed their Italian counterparts, where benchmark yields moved up half a point during the month to their highest level since February. The uncertainty created by Italy's constitutional referendum, due to take place in early December, has increased the focus on other negative factors, notably the country's weak banking system. Italy's sluggish growth has contrasted with Spain's strong economy, in spite of both countries enjoying a fiscal stimulus from expanded budget deficits, as they continue to defy the European Commission's fiscal targets for member countries.

In the absence of more supportive economic data, we feel speculation suggesting an impending shift in monetary policy by the ECB is somewhat premature. While an adjustment of the ECB's current quantitative easing program is necessary, in order to accommodate structural constraints within eurozone bond markets, we think such measures are more likely to be taken to facilitate further monetary easing beyond the current March 2017 deadline, rather than risk the potentially detrimental tightening effects of any perceived tapering of monetary stimulus. Indeed, at the ECB's October meeting, ECB President Mario Draghi described the prospect of an abrupt end to quantitative easing as unlikely, though policymakers' thinking should become clearer when the ECB releases updated growth and inflation forecasts at its next meeting in early December.

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