FIXED INCOME

Global Economic Perspective: October

October 15, 2018

Christopher J. Molumphy, CFA
Executive Vice President,
Chief Investment Officer,
Franklin Templeton Fixed Income Group

David Zahn, CFA, FRM
Head of European Fixed Income,
Senior Vice President,
Franklin Templeton Fixed Income Group

John Beck
Director of Fixed Income, London
Senior Vice President,
Franklin Templeton Fixed Income Group

Michael Materasso
Senior Vice President,
Head of Insurance Asset Management,
Franklin Templeton Fixed Income Group

Roger Bayston, CFA
Head of Quantitative & FinTech Strategies
Franklin Templeton Fixed Income Group

Perspective from Franklin Templeton Fixed Income Group

In this Issue:

US Economy's Fundamentals Justify Optimism, but Inflation Still Subdued

The current widespread optimism about the US economy is largely justified, in our view, by its strong fundamentals, particularly the positive backdrop for consumers. Despite the economy's robust growth, we do not view the recent rise in US Treasury yields as heralding the start of a major selloff across bond markets. Inflation shows little sign of breaking out of its pattern of sluggish and limited gains, as long-term constraints such as demographics and technology continue to exert downward pressure on prices, though the recent rise in energy prices could act as an offset if sustained. The Trump administration's trade policies and the upcoming midterm congressional elections create further uncertainty among investors about the outlook for 2019, which we believe could serve to cap any rise in yields over the coming months.

Global Economy Maintains Solid Momentum as Trade Concerns Subside

The impact of recent developments in emerging markets remains marginal, in our view, with little effect so far on the outlook for the G7 economies. In the absence of a major crisis—for example, a sovereign default—we believe the global economy's solid momentum should be maintained, underpinned by the strength of US demand. Consequently, we see little reason for the leading central banks to deviate significantly from the monetary policy trajectories they have currently laid out. Concerns among investors about trade tensions appear to have subsided somewhat for the time being, though the ongoing uncertainty around US policy means this issue could swiftly create further market volatility.

Italy's Budget Talks with EU Could Lead to Looser Fiscal Policy Elsewhere in Eurozone

As negotiations on the United Kingdom's (UK's) withdrawal from the European Union (EU) drag on, Italian politics are also likely to present a challenge for policymakers in Brussels. The EU faces a tough task in persuading Italy's populist government to maintain fiscal discipline without increasing support among the country's voters for eurosceptic policies. However, a compromise allowing a limited expansion of the Italian budget seems the most likely outcome, in our view. Such a deal could also encourage other eurozone countries to modestly loosen their fiscal stance. Any resulting growth stimulus may prove a timely counterbalance to the expected phasing out of the European Central Bank's (ECB's) bond purchases at the end of 2018.

US Economy's Fundamentals Justify Optimism, but Inflation Still Subdued

The current widespread optimism about the US economy is largely justified, in our view, by its strong fundamentals, particularly the positive backdrop for consumers. If the fiscal stimulus that has likely contributed the most to the present elevated rate of expansion has also sparked some more secular growth-enhancing trends—for example, productivity gains through higher capital expenditure—then it could provide a further leg to the already prolonged economic cycle. However, we believe it is still too early to determine whether such developments are occurring.

Despite the economy's robust growth, we do not view the recent rise in US Treasury yields as heralding the start of a major selloff across bond markets. Inflation shows little sign of breaking out of its pattern of sluggish and limited gains, as long-term constraints such as demographics and technology continue to exert downward pressure on prices, though the recent rise in energy prices could act as an offset if sustained. The Trump administration's trade policies and the upcoming midterm congressional elections create further uncertainty among investors about the outlook for 2019, which we believe could serve to cap any rise in yields over the coming months.

US Treasury yields moved higher over much of September, and early in October, benchmark issues posted their largest daily jump in yields since the 2016 US presidential election, climbing to levels last seen in 2011. The move appeared to be an acknowledgment by investors of the sheer weight of positive news about the US economy, along with reduced concerns about other parts of the world, as fears of a major crisis in emerging markets such as Turkey and Argentina receded and a revised version of the North American Free Trade Agreement (NAFTA) was agreed. Consensus estimates for third-quarter US growth remained above 3%, amidst speculation about whether the effects of the recent fiscal stimulus could last into 2019.

The strong data included September's reading of the Institute for Supply Management's (ISM's) purchasing managers' index (PMI) covering services, which was the highest recorded since its inception in 2008. Although the equivalent index for manufacturing dipped, missing consensus forecasts, it remained relatively high and the ISM described demand in this area as "robust." A leading measure of consumer confidence posted another rise in September, its best showing since 2000, following August's significant improvement. The optimism about the economy, with investors generally anticipating another strong set of earnings in the third quarter, helped to push stock market indices up to new record highs by the end of September, though concerns about rising bond yields soon tempered bullish sentiment.

September's labour market report maintained the strong momentum already in place for a prolonged period. Though the monthly payroll figure was below consensus expectations, possibly due to weather-related issues, this shortfall was more than offset by a significant upward revision to August's total. The unemployment rate fell to 3.7%, its lowest level for nearly 50 years. Wage growth dipped a touch from August's nine-year high, coming in at 2.8% year-on-year (y/o/y).

As widely predicted, the US Federal Reserve (Fed) raised interest rates at its September meeting, the third hike so far this year. With the US central bank's favoured measure of inflation, the core personal consumption expenditures price index, steady at 2.0% y/o/y in August for the fourth consecutive month, the fed funds rate moved above inflation for the first time since the global financial crisis of 2007–2008. A similar decision by the Fed in December had already been discounted in the fed fund futures market, but following the robust economic data releases during September, expectations for the number of anticipated interest-rate hikes in 2019 increased from one to two, although this still lagged the Fed's projected three upward moves.

In a series of public comments, Fed Chair Jay Powell underlined how unusual was the current combination of historically low levels of inflation and unemployment, but said that policymakers did not see evidence of overheating in the labour market. He also emphasised the uncertainty involved in estimating the neutral long-run level of interest rates, which the Fed's latest median forecasts put at 3.0%. His remarks added weight to the view that policymakers would likely maintain a cautious approach, with any potential acceleration in the pace of tightening predicated on unambiguous data signals, rather than a pre-emptive move triggered by their perceptions of a forthcoming rise in inflation.

In the latest escalation of US trade policy, President Trump widened the amount of Chinese imports subject to a 10% tariff to US$200 billion, around half of the total amount entering the United States. A subsequent move to a higher levy of 25% on Chinese imports was touted for 2019, in the absence of progress on US demands for a reduction of the trade imbalance between the two countries and a halt to the so-called "forced technology transfer" requirements on US companies trading in China. China responded by placing additional 10% tariffs on US$60 billion of American goods. Given the political resonance of the dispute for the leaderships of both countries, it remained difficult to see how the standoff on trade would be resolved.

Global Economy Maintains Solid Momentum as Trade Concerns Subside

In contrast to the intensified trade measures against China, talks between the United States and Canada aimed at revising the terms of NAFTA produced a last-minute resolution of their differences, with Canada agreeing to join the amended deal recently reached between the United States and Mexico. The updated trade arrangements —known as the United States-Mexico-Canada Agreement (USMCA)—appeared somewhat more restrictive in certain areas, notably autos, but more open in others, such as agriculture. The USMCA also specified a time limit of 16 years, in contrast to the previously indefinite term for NAFTA.

The Canadian dollar and Mexican peso both rose in reaction to the news, with investors apparently relieved that the potential threat to trade flows within North America had receded. In the case of the Canadian dollar, its move higher was also driven by widespread expectations the revised agreement could prompt the Bank of Canada to swiftly tighten monetary policy, after policymakers there had previously cited trade uncertainty as a reason for keeping interest rates on hold.

The first round of Brazil's presidential elections took place in early October, and as predicted by earlier polls the right-wing populist candidate Jair Bolsonaro attracted the most support. Bolsonaro's main rival, Fernando Haddad from the left-wing Workers' party, ended in second place, setting up a decisive second round of voting at the end of the month. In the weeks leading up to the election, the Brazilian real recovered some ground after declining for much of the year. Market participants appeared to be speculating that a Bolsonaro victory could be the most attractive outcome for the Brazilian economy, which has struggled to shake off the effects of a deep recession.

The International Monetary Fund (IMF) announced an increase of US$7.1 billion in the size of its bailout package to Argentina, bringing the total to just over US$57 billion, its largest-ever such programme. Although the extra amount was lower than widely forecasted, the IMF pledged to speed up the availability of the funds, boosting by US$19 billion the amount available to the Argentinian government by the end of 2019. The latest package was only agreed following the resignation of the head of the Argentinian central bank, over reports of disagreement on the extent of foreign-exchange intervention. Subsequent alternative policy measures aimed at keeping the Argentinian peso in a trading band against the US dollar led to an immediate rally in the currency, though the longer-term outlook for the peso remained uncertain.

The rally in oil prices that had begun in mid-August gathered pace towards the end of September, with both international and US benchmarks hitting their highest levels in nearly four years. US sanctions on Iran's oil exports—due to come into effect at the start of November—and lower production in Venezuela appeared to be the main short-term drivers behind the rally. But the price rise also reflected underlying optimism among investors about the strength of demand across the global economy, as well as speculation that infrastructure problems could limit any expansion of US shale oil production in response to higher prices.

The impact of recent developments in emerging markets remains marginal, in our view, with little effect so far on the outlook for the G7 economies. In the absence of a major crisis—for example, a sovereign default—we believe the global economy's solid momentum should be maintained, underpinned by the strength of US demand. Consequently we see little reason for the leading central banks to deviate significantly from the monetary policy trajectories they have currently laid out. Concerns among investors about trade tensions appear to have subsided somewhat for the time being, though the ongoing uncertainty around US policy means this issue could swiftly create further market volatility.

Italy's Budget Talks with EU Could Lead to Looser Fiscal Policy Elsewhere in Eurozone

The effect of trade tensions on European manufacturers was evident in September's reading of a leading PMI covering the eurozone. According to this data, factories in the region recorded their slowest increase in output since mid-2016. However, in a sign of the strength of resilient domestic demand across the eurozone economy, notwithstanding the slowdown in manufacturing, the survey indicated an overall level of activity consistent with continued strong growth.

ECB President Mario Draghi re-iterated his confidence that inflation was on track to meet the central bank's target of around 2%, pointing to annualised wage growth across the eurozone in the second quarter that showed the biggest rise in six years. Despite slightly downgrading its growth forecasts, the ECB stated it expected higher wages and government spending to compensate for the headwinds faced by the region's exporters. The central bank also confirmed its planned reduction in monthly bond purchases from €30 billion to €15 billion, and indicated it remained on course to cease purchases completely at the end of this year, while continuing to re-invest the proceeds of existing holdings.

The improvement in the region's labour market was underlined by the fall in the unemployment rate in August to close to 8%, the lowest level since 2008, compared with a peak of more than 12% seen during the 2012–2013 eurozone debt crisis. Nevertheless, inflation data for September showed little sign of underlying pressures, with the core reading slowing slightly to 0.9% y/o/y.

Concerns about Italy were fueled by news that the country's coalition government of populist parties planned to push through a significant increase in public spending, setting up a potential clash with the EU over limits on the budgets of member countries. The budget proposals appeared to deal a blow to the credibility of the more moderate Italian finance minister Giovanni Tria, although he continued to emphasise the government's commitment to reducing Italy's public debt, the second largest as a percentage of gross domestic product in the eurozone. By early October, benchmark Italian government bond yields had moved up to their highest level since 2014, but—in contrast to the trends seen in August, when political uncertainty in Italy prompted investors to buy German Bunds, driving down their yields—Bund yields followed the path of US Treasuries, moving up to their highest level since May.

As negotiations on the UK's withdrawal from the EU drag on, Italian politics are also likely to present a challenge for policymakers in Brussels. The EU faces a tough task in persuading Italy's populist government to maintain fiscal discipline without increasing support among the country's voters for eurosceptic policies. However, a compromise allowing a limited expansion of the Italian budget seems the most likely outcome, in our view. Such a deal could also encourage other eurozone countries to modestly loosen their fiscal stance. Any resulting growth stimulus may prove a timely counterbalance to the expected phasing out of the ECB's bond purchases at the end of 2018.

For timely investing tidbits, follow us on Twitter @FTI_Global and on LinkedIn.

The comments, opinions and analyses are the personal views expressed by the investment managers and are intended to be for informational purposes and general interest only and should not be construed as individual investment advice or a recommendation or solicitation to buy, sell or hold any security or to adopt any investment strategy. It does not constitute legal or tax advice. The information provided in this material is rendered as at publication date and may change without notice, and it is not intended as a complete analysis of every material fact regarding any country, region market or investment.

Data from third-party sources may have been used in the preparation of this material and Franklin Templeton Investments ("FTI") has not independently verified, validated or audited such data. FTI accepts no liability whatsoever for any loss arising from use of this information, and reliance upon the comments, opinions and analyses in the material is at the sole discretion of the user. Products, services and information may not be available in all jurisdictions and are offered by FTI affiliates and/or their distributors as local laws and regulations permit. Please consult your own professional adviser for further information on availability of products and services in your jurisdiction.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.

What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. 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. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets.