FIXED INCOME

Slowdown Doesn't Mean Stop. Our View on US Interest Rates, Inflation and China

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While the US Federal Reserve (Fed) decided to leave interest rates unchanged at its January policy meeting, the market seems to be thinking the Fed may press pause for an extended period. A prolonged US government shutdown has heightened concerns the economy could be at a tipping point, but Sonal Desai, Chief Investment Officer, Franklin Templeton Fixed Income Group, weighs in on why the notion the Fed won't raise rates at all this year "is misguided."

In my view, expectations that the US economic cycle is coming to an end are highly overstated right now. Underlying US economic fundamentals are still pretty strong. The government shutdown will cause a somewhat weaker reading for first-quarter gross domestic product (GDP) growth, but most if not all of it will be simply shifted to a stronger second-quarter growth number. I do think this year we will see some moderation of the 3% growth we saw in 2018, but it's moderation to a level which is still above potential. This is really important to emphasise.

Several months ago, we thought the Federal Reserve might raise interest rates four times this year. In light of recent developments, the Fed has indicated it intends to adopt a more cautious and patient stance, taking time to assess signs that global growth might be weakening as well as the extent and impact of volatility in financial markets, notably equities.

Indeed, the January Federal Open Market Committee (FOMC) meeting marked a clear, dovish shift in the Fed's tone; nonetheless, I would still anticipate that it will deliver at least two more rate hikes this year. I believe that the market's assumption that the Fed will not raise interest rates at all this year is very misguided, against a background of continued economic strength.

Inflation Risk

I think risks to inflation are definitely to the upside. This might sound strange because it seems the entire world is thinking about a US recession, not about inflation. But barring a major external shock I really don't think the threat of recession is imminent. The US has a very strong labour market, which is starting to push up wages, while robust consumption supports firms' pricing power.

This points to somewhat higher inflation—likely not much higher, but higher nonetheless.

I would also point out that we don't actually need more inflation to see higher Treasury yields on the long end. I think higher long-term rates will come almost independently on the back of the very strong underlying economy, which supports an ongoing normalisation of monetary policy, with a higher fed funds rate and continued quantitative tightening.

I think the Fed will continue to normalise monetary policy because the US economy has already shown it can withstand higher interest rates compared to where we are today. When we saw the US 10-year Treasury move above 3% last year, there was some panic, some dislocation in the short term. But then financial markets stabilised, and the economy kept growing at a robust clip. Therefore, rising rates should not be a reason for investors to panic, in our view.

We will get periods of volatility in the year going forward, but active managers can take advantage of these periods to seek out potential opportunities.

China Slowing

Looking out more globally, the US economy isn't the only one facing a moderation in growth. China's gross domestic product grew 6.6% in 2018, the slowest growth rate in more than two decades. Our view on China has become somewhat more pessimistic than we've had historically.

While we are not anticipating a rapid a downturn (a hard landing), growth estimates are probably going to be closer to something like 6% this year, in our view. That's probably healthy for an economy the size of China's, especially as it continues to rebalance away from excessive reliance on investment and strives to keep leverage ratios under control.

However, I think the downside risks to China's growth have risen: the number of silver bullets that China has left to fire is dramatically lower than at any other time in the last decade—it has much less scope to increase credit, and it faces a more adversarial international trade environment. That's something which we should all be concerned about.

In my view, the global outlook is a bit more at risk from China today than it was say two or three years ago. This is something which we will be monitoring extremely carefully.

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