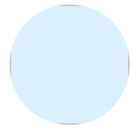
Global Economic Perspective: May

May 13, 2016



Perspective from Franklin Templeton Fixed Income Group

In This Issue:

US Economy Sluggish, but Signs of Higher Wage Growth

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US Dollar Weakness and China Data Boost Commodities

Global financial markets remain concerned about the health of the global economy, but we are sticking to our belief that such pessimism is overdone, though a wider adoption of policies to boost structural growth would clearly be welcome. At the same time, we do find ourselves more in line with market consensus in our doubts about central bank policies on negative interest rates, which may result in market distortions.

Eurozone Growth Surprisingly Strong

The eurozone looks to be growing at close to its maximum potential in the absence of structural reforms, the likelihood of which seems to have been pushed back by the trend toward more populist governments since the eurozone debt crisis. The road toward the European Central Bank's (ECB's) target of 2% inflation will likely be long, but we maintain our belief that the central bank is currently pursuing all of the politically feasible policies at its disposal that can encourage a further revival of economic activity and help achieve that goal.

US Economy Sluggish, but Signs of Higher Wage Growth

The conundrum that has characterized US economic data for some time—specifically, the disparity between a labor market that has tightened to levels close to most definitions of full employment and the economy's sub-trend growth rate in recent quarters—continued in April. Nevertheless, we remain cautiously optimistic that the solid fundamentals in the United States will help the economy to begin moving closer to its trend growth rate later in the year, as the healthy labor market could increasingly support higher incomes and encourage consumers to spend. Given our broadly positive economic outlook, we think it is quite possible the Fed may move to raise interest rates somewhat quicker than market consensus forecasts are predicting.

US first-quarter 2016 gross domestic product (GDP) figures came in a touch weaker than expected at an annual rate of 0.5%, the lowest level in two years and the third consecutive quarter of slowing growth. The reading extended a pattern of weakness regularly apparent in the country's first-quarter GDP reports since the global financial crisis, leading some analysts to question if an element of seasonality was consistently affecting the measurement of growth. The ripple effects of the precipitous fall in energy prices were again evident, as business investment fell 3.5% over the first quarter, its third straight quarterly decline. Despite a pullback in the US dollar during the quarter, the currency's prior strength took a further toll on exports, which shrank 2.6%, compared with a 2.0% fall in the fourth quarter of 2015. US consumer spending, which accounts for around seven-tenths of GDP, expanded at a slower pace of 1.9%, down from 2.4% previously, with signs that the volatility seen in financial markets at the start of the year had made consumers a little more cautious.

The April payroll report to some extent reflected the weaker first quarter, being more of a mixed bag than in previous months, as job growth tapered from its past breakneck speed. The 160,000 jobs added were some way shy of consensus expectations, and March's figure was also revised down a little, while the unemployment rate stayed at 5.0%. Employment in the retail, construction, and leisure and hospitality sectors showed some of the largest slowdowns. But there was a reminder of the underlying strength of the labor market as wage growth ticked up, increasing from 0.2% to 0.3% month-on-month (m/m) and from 2.3% to 2.5% over 12 months.

A disappointing US corporate earnings season confirmed the tough backdrop for many companies, though some domestically focused areas like health care produced more encouraging results. Industrial production slumped 0.6% m/m in March, much more sharply than expected, but importantly, auto sales bounced back strongly in April from a weak March reading, an encouraging turnaround for a measure that has restrained factory output. Durable goods orders remained sluggish as well in March, indicating that large parts of manufacturing continue to suffer from the combination of low oil prices and the strong dollar, and may act as a drag on overall US activity in coming months.

Soft inflation data implied a business environment in which many companies lack pricing power, in turn hindering the ability of employees to push for stronger wage gains. In March, the core consumer price index rose 0.1% m/m, a little softer than consensus forecasts, to leave the annual core figure up 2.2%. Despite a March rise in energy prices within the Consumer Price Index after three months of negative readings, declines elsewhere limited the rise in headline inflation to 0.1% m/m, while the annual headline rate fell to 0.9%. The Fed's preferred inflation measure, the core personal consumer expenditures price index, also rose 0.1% m/m in March, while the annual rate edged down a tenth to 1.6%. However, the same report contained some positive news on income, which grew by a solid 0.4% m/m. Indeed, the overall picture remained slightly unclear, with relatively high readings from measures such as the Atlanta Fed's Wage Growth Tracker hinting that inflationary pressures from wage gains could possibly be greater than indicated by other data.

The Fed's decision to leave interest rates unchanged at its April meeting came as little surprise, but its accompanying statement was notable for the removal of references to the restraining influence of global weakness and China's slowdown. For the third meeting in a row, the Fed declined to comment on the balance of risks facing the economy, noting only the contrast between weaker growth (which it saw as transitory) and a strong labor market. The central bank's forecasts looked toward two increases in policy rates over the remainder of 2016, whereas consensus market estimates remained far less advanced, and were pushed out even further following the April jobs report. But as we believe the most probable economic scenarios are tilted toward a pickup in growth and inflation, it seems possible to us that the Fed could tighten monetary policy a little quicker than widely expected.

US Dollar Weakness and China Data Boost Commodities

With the US economy sluggish and the Fed showing little sign of hurrying to raise interest rates, the US dollar remained under pressure, and by the start of May it had fallen to its lowest level against a basket of other major currencies since the start of 2015. Nowhere was the dollar's weakness more evident than relative to the Japanese yen, which reached its highest point against the US currency in more than 18 months. The yen benefited from the Bank of Japan's (BOJ's) decision to abstain from any further monetary easing in April, which came as a surprise to some market participants. The Japanese currency had already moved higher since January in the wake of the BOJ's introduction of negative interest rates—a move that has hindered the central bank's efforts to reach its inflation target—and some analysts thought this rise would prompt further policy easing from the BOJ.

The weakness in the US dollar helped to drive the rally in commodity and, most importantly, oil prices that has been in place since February. In fact, the strength was such that some global commodity benchmarks had their best month of returns since 2010. Oil prices in the United States reached 2016 highs and rose almost 20% in April (to roughly US$46 per barrel), the largest monthly increase in a year, as an outlook for accelerating declines in US crude output boosted confidence.

The other tailwind helping commodities was China, where data suggested demand was recovering as first-quarter GDP figures revealed that the economy grew at an annual rate of 6.7%. The data pointed to a pickup in March after a soft start to the year, indicating a broad stabilization of the economy and helping to soothe fears about the extent of the country's slowdown. During March, industrial production rose at its fastest pace in nine months and further signs of a recovery in the housing market added to positive sentiment. However, other data raised concerns about the extent to which credit was expanding, as the Chinese government responded to the weaker economy by increasing monetary and fiscal stimulus.

Elsewhere in the global economy, the central banks of Australia and Singapore eased monetary policy, with the Monetary Authority of Singapore citing a moderation of China's growth momentum as one of the reasons for its decision. Despite recent healthy growth and employment numbers indicating that the Australian economy had weathered past falls in commodity prices relatively well, the Reserve Bank of Australia responded swiftly to soft inflation data by cutting interest rates to a record low, and it reduced its inflation target for 2016 from 2%–3% to 1%–2%. Argentina successfully rejoined international capital markets with the largest-ever sovereign bond issue from an emerging-market country, receiving orders of almost US$70 billion for its US$16.5 billion issue.

Global financial markets remain concerned about the health of the global economy, but we are sticking to our belief that such pessimism is overdone, though a wider adoption of policies to boost structural growth would clearly be welcome. At the same time, we do find ourselves more in line with market consensus in our doubts about central bank policies on negative interest rates, since the resulting market distortions—which are yet to be fully explored—may undermine the desired effects.

Eurozone Growth Surprisingly Strong

Beating consensus forecasts, the eurozone's 0.6% quarter-on-quarter (q/q) expansion in the first quarter meant that output in the region had finally surpassed the level seen before the global financial crisis, and it underlined how a range of tailwinds has helped to bolster domestic demand and reduce unemployment. Chief among these has been the ECB's monetary easing program, as lower interest rates and cheap loans have encouraged consumers to spend and businesses to invest, although lower energy prices and previous falls in the euro have also had a significant effect. A surprisingly strong performance by the French economy helped to boost the overall growth rate, with the country experiencing the biggest increase in household spending since 2004. Outside of the single-currency area, growth in the United Kingdom in the first three months of the year slipped to 0.4% q/q, amid increasing signs that uncertainty about the outcome of the country's forthcoming referendum on its European Union membership was slowing the economy.

Furthermore, after several years of austerity, several eurozone countries have benefited from a limited easing of fiscal restrictions. An influx of refugees has probably increased overall expenditure in Germany, while in Spain the absence of a national government since inconclusive elections at the end of 2015 has allowed some of the country's regional administrations to spend more. Spain has scheduled fresh elections for June, but according to polls they appear unlikely to produce significantly different results, with an end to the political stalemate still seemingly some way off.

Inflation in the eurozone remained weak and showed little sign of picking up soon. Core inflation slowed from 1% in the year to March to 0.7% in the year to April, while the headline figure for April showed an annual decline of 0.2%. The European Commission downgraded its forecasts for headline inflation in the eurozone, predicting a rise of only 0.2% for this year as whole—down from its forecast of 1% as recently as last November—and 1.4% for 2017.

More details were announced about the ECB's intention to begin purchases of corporate debt, now scheduled to kick off in June. This element of the ECB's program has created some unusual distortions in markets, as investors have moved in anticipation of the buying power of the central bank. Many companies that have issued debt in a variety of currencies have seen yields on their euro-denominated bonds fall substantially below their bonds of roughly equivalent maturity denominated in either US dollars or British pounds.

There were further signs that some eurozone countries were starting to tackle past problems, as the Italian government orchestrated the creation of a privately backed fund to deal with a backlog of bad loans accumulated by Italian banks during the country's long-running recession. The fund raised over €4 billion from the financial sector but appeared unlikely to provide a long-term solution to the problem, as Italian lenders hold around €200 billion of loans to borrowers who are insolvent, about 40% of which are yet to be written down on their balance sheets.

While growth in the eurozone has clearly improved, we believe the latest data speak more to weakness elsewhere in the global economy than strength in the region itself. The eurozone looks to be growing at close to its maximum potential in the absence of structural reforms, the likelihood of which seems to have been pushed back by the trend toward more populist governments since the eurozone debt crisis. The road toward the ECB's target of 2% inflation will likely be long, but we maintain our belief that the central bank is currently pursuing all of the politically feasible policies at its disposal that can encourage a further revival of economic activity and help achieve that goal.

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