

## Global Economic Perspective: June

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Perspective from Franklin Templeton Fixed Income Group



Christopher  
Molumphy

Michael  
Materasso

Roger  
Bayston

John  
Beck

David  
Zahn

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#### **Positive Sentiment on US Economy Dented by Weak Payroll Report**

Our view is that the US economy remains on course to pick up over the rest of this year, despite May's disappointing payroll report and the US Federal Reserve's (Fed's) subsequent decision at its June meeting to leave interest rates unchanged. We do not place too much importance on this single piece of data and believe the economy's robust fundamentals are likely to fulfill the Fed's criteria for tightening monetary policy fairly soon.

#### **Strength of Oil Market Provides Encouraging Signal on Global Growth**

A more negative tone in investor sentiment about the global economy has come to the fore since the weak US payroll report, which added to concerns about Britain's European Union (EU) referendum. In a global environment characterized by subdued growth and central bank policies that have created numerous distortions in financial markets, periods of volatility are likely to occur regularly. Despite such market noise, we believe the global economy continues to expand at a reasonable pace, as indicated by measures like the robust demand for energy.

## **Europe's Modest Growth, Minimal Inflation and Sizable Monetary Easing Likely to Continue**

Subject to unknowns such as the impact of Britain's referendum on its EU membership, our outlook for Europe is essentially for more of the same: more moderate growth, minimal inflation and significant monetary easing by the European Central Bank (ECB). Populist politics are likely to hinder efforts to improve the eurozone's structural constraints, but the longer such issues are avoided by governments, the more difficult it will be to overcome the challenges they represent.

## **Positive Sentiment on US Economy Dented by Weak Payroll Report**

For much of May, broadly upbeat data suggested the US economy's first-quarter 2016 weakness had been transitory, but at the start of June a far weaker-than-expected monthly payroll report raised doubts once more among investors. With several Fed policymakers adopting a more hawkish tone during May, expectations had built steadily that an increase in interest rates might be announced at the Fed's June or July meetings. However, the reduced pace of job creation led to a swift reversal in sentiment, even as forecasts for second-quarter growth continued to point to a marked uptick in activity.

Our view is that growth remains on course to pick up over the rest of this year, even though May's disappointing payroll report (along with external factors such as the uncertainty surrounding Britain's EU referendum) helped persuade the Fed to hold back temporarily from raising interest rates at its June meeting. Monthly payroll data have historically been volatile and prone to revision, and we do not place too much importance on this single reading. The numbers were impacted by one-offs such as a labor dispute at a large telecommunications firm, but clearly, given the recent extreme weakness, the labor market report for June assumes heightened significance.

Our positive growth outlook for the United States rests on the economy's solid underpinnings. The labor market has improved beyond recognition since the depths of the financial crisis, wages have risen consistently for some time now, and consumers' balance sheets have been boosted by the health of the housing and stock markets. We believe such robust domestic fundamentals are likely to provide the Fed with the

justification to increase interest rates, possibly somewhat quicker than market consensus forecasts are predicting.

The impact of the May monthly payroll report was magnified by its contrast with other positive data. In a sign that the tighter labor market could be feeding into consumers' habits, household spending rose in April by 1.0% month-on-month (m/m), the largest monthly increase since August 2009, or by 0.6% m/m when adjusted for inflation, with the jump largely due to additional expenditure on autos. Retail sales also posted a sizable gain of 1.3% m/m in April, followed by a rise of 0.5% m/m in May. Housing data continued to indicate a solid market, as the S&P Case-Shiller 20-city index remained steady at 5.4% year-on-year (y/y) growth in March. During April, existing home sales strengthened from the previous month and new home sales saw the sharpest monthly gain since 1992, though this measure is known to be volatile.

For the overall economy, first-quarter growth, initially measured at an annualized 0.5%, was revised upward to 0.8%, with a fall in business investment not as steep as previously estimated. But data from those parts of the economy that have been underperforming remained weak over May. Chief among these was manufacturing, for which the Institute for Supply Management's (ISM's) manufacturing purchasing managers' index (PMI) for May rose slightly but remained sluggish at 51.3, indicating only marginal expansion. Though there was some encouragement from the stronger new orders and export segments within the ISM survey, other readings—such as the Markit PMI—painted a weaker picture.

The May payroll number came in at 38,000, well below expectations of 160,000, and was accompanied by downward revisions to data for previous months, which reduced the three-month moving average to 116,000. A fall in the unemployment rate to 4.7% was largely explained by a drop in the labor force participation rate. Among the more positive explanations put forward by market analysts was the possibility that hiring was slowing as the economy closes in on full employment. There was some comfort in the accompanying average hourly earnings data, which showed an increase of 2.5% in May compared with the previous year.

According to the minutes from its April meeting, the Fed is focusing on three criteria to decide whether the economy is ready for higher interest rates: signs of a rebound in the second quarter, a further strengthening in the jobs market and progress in reaching its 2% medium-term inflation goal. For the last of these, the data for April showed

little movement, with the Fed's preferred measure, the core personal consumer expenditures price index, rising only 0.2% m/m and an unchanged 1.6% y/y. The equivalent core Consumer Price Index numbers came in at 0.2% and 2.1%—the latter a fall of 0.1% from the previous month, though still above the Fed's 2% target—while at the headline level there was a monthly rise of 0.4% and an annual rise of 1.1%, as energy prices registered another substantial annual fall of 8.9%, despite having risen for the two previous months.

As Fed Chair Janet Yellen underlined in a speech shortly after the May payroll report was released, the bank's monetary policy will not be based on a single piece of data. She also argued that the positive forces acting on the economy in support of job growth and inflation should outweigh the negative ones, providing a platform for gradual increases in interest rates. But for such a move to occur in the coming months, it would seem to require both a swift rebound in payroll data and for financial markets to be soothed by a British decision to remain in the EU.

### **Strength of Oil Market Provides Encouraging Signal on Global Growth**

The US dollar moved higher during May, recovering some of its steep losses in previous months, only to fall back once more following the weak US payroll report. A stronger US dollar generally hurts oil prices by making imports more costly for holders of other currencies, but despite the dollar's rise, oil prices climbed steadily over the month, boosted by supply disruptions affecting oilfields in Canada and Nigeria, where output in April fell to a 20-year low. As the dollar fell at the start of June, prices received another fillip and proceeded to move above US\$50 per barrel for the first time in 2016.

The oil market has seen supply from US shale producers gradually decline in the face of the prolonged slump in prices, which hit their lowest level in more than a decade in February. Cheaper prices have stimulated demand from US consumers, with their gasoline consumption in the second week of May estimated to be the second highest on record. Overall global demand has remained robust, even as economic growth forecasts around much of the world have generally moved a little lower this year. The excess stocks that built up as the market struggled to find equilibrium appear to be slowly unwinding, helped by booming demand from countries like India, which has overtaken China as the main source of growth. According to the International Energy Agency, India is likely to surpass

Japan during 2016 as the world's third biggest consumer of oil behind the United States and China.

In Japan, better-than-expected first-quarter gross domestic product figures were overshadowed by other data showing softer inflation. The Japanese government reacted by delaying a planned increase in the consumption tax that was expected to weigh on growth. Elsewhere in Asia, figures for China's foreign reserves in May showed a slight decline to US\$3.19 trillion from US\$3.22 trillion in April, while toward the end of the month, the People's Bank of China set the trading band for the Chinese renminbi at its lowest level against the US dollar in more than five years. Despite the renminbi's weakness, so far this year the Chinese central bank has managed to stabilize the decline in its cash reserves, which during 2015 fell sharply from their mid-2014 peak of close to US\$4 trillion. Net capital outflows—which have contributed to the fall in the renminbi—were estimated by the Institute of International Finance to be US\$27 billion in May, down from the US\$120 billion average monthly pace seen last year.

Both Russia and South Korea cut interest rates, while in Latin America, Brazil's senate voted to suspend President Dilma Rousseff for manipulating the country's budget. Her interim replacement was Vice President Michel Temer, who as expected unveiled a center-right cabinet that included Henrique Meirelles, a former market-friendly president of the Brazilian central bank, as finance minister. First-quarter figures showing Brazil's economy contracted by 5.4% from a year earlier—the fifth consecutive quarter of contraction—underlined the difficulties facing the country.

A more negative tone in investor sentiment about the global economy has come to the fore since the weak US payroll report, which has added to concerns about Britain's EU referendum. In a global environment characterized by subdued growth and central bank policies that have created numerous distortions in financial markets—not least of which are the negative interest rates now prevalent in many countries—periods of volatility are likely to occur regularly. Despite such market noise, we believe the global economy continues to expand at a reasonable pace, as indicated by measures like the robust demand for energy.

**Europe's Modest Growth, Minimal Inflation and Sizable Monetary Easing Likely to Continue**

European economic data provided further indications the region's current growth was satisfactory if unspectacular. After first-quarter figures showed surprisingly strong expansion in the eurozone, at its June meeting the ECB modestly upgraded its growth forecast for the current year from 1.4% to 1.6%, while at the same time saying it expected expansion to slow slightly in the second quarter. The central bank also renewed its call to member governments to lower their reliance on austerity and monetary policy in favor of growth-enhancing fiscal and structural measures, as a means of overcoming the region's problems of excess capacity and challenging demographics.

At the start of June, the ECB embarked on the latest element of its monetary easing program: purchasing investment-grade euro-denominated corporate bonds with maturities of between two and 30 years from non-financial companies. Since the plan was announced in March, yields in the euro corporate bond market have fallen sharply, such that yields on some of the paper issued by the highest-rated companies have moved into negative territory. (The ECB has stated that its purchases will potentially include any investment-grade corporate bond yielding more than the central bank's deposit rate, which is currently -0.4%.) In this respect, corporate bonds were following many of the region's sovereign bond markets, where negative yields have become increasingly common, with the average yield on German Bunds falling below zero for the first time in early June.

Some of the impetus driving eurozone yields lower came from external factors, such as the May US payroll report. However, at the time of this writing, risk aversion among investors was also heightened by Britain's impending referendum on EU membership, the result of which polls suggested could be extremely close. Further uncertainty surrounded the outcome of fresh elections in Spain scheduled for the end of June, following the inconclusive results and political deadlock that resulted from the country's previous round of voting in December 2015. There was more positive news from Greece, however, where the government reached a provisional agreement with creditors during May to allow a further disbursement of funds from the country's bailout package.

The effects of the ECB's monetary stimulus have helped to stabilize growth in the eurozone (as have cheaper energy prices), but excess capacity continues to hamper the central bank's efforts on inflation. Annual headline inflation in the single-currency region remained negative for the fourth consecutive month in May, and core inflation



grew at only 0.8% compared to a year earlier. At its June meeting, the ECB nudged its headline inflation forecast for the current year a touch higher, from 0.1% to 0.2%, but left its 1.6% forecast for 2018 unchanged. With this in mind, the Organisation for Economic Co-operation and Development urged the ECB to be ready to do more to expand its balance sheet—even though the absolute size of the ECB's balance sheet, including its corporate purchases, is projected to become larger than either the Fed's or the Bank of Japan's by early 2017.

Subject to unknowns such as the impact of Britain's EU referendum, our outlook for Europe over the medium term is essentially for more of the same. By this we mean more growth at a moderate level (but close to what can be expected given the structural constraints), an extended period in which inflationary pressures are either completely absent or negligible and, as a result of these factors, a monetary stance from the ECB that should be extremely accommodating. The political landscape is likely to remain a significant hindrance to improving the region's economic performance; with populist political parties continuing to exert increased influence on voters, the likelihood of progress in grasping the nettle of reform still appears some way off. But as ECB President Mario Draghi has repeatedly stressed, the longer such issues are avoided by member governments, the more difficult it will be to overcome the challenges they represent.

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