



# Global Economic Perspective

PERSPECTIVE FROM THE FRANKLIN TEMPLETON FIXED INCOME GROUP®



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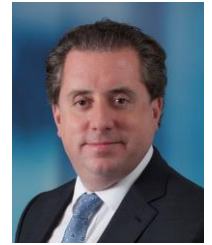
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## Respectable US Growth Underpinned by Constructive Conditions, but Potential Risks Ahead

We see the US economy as maintaining its current path of respectable but not overly robust growth. Underlying fundamentals and economic momentum remain constructive, while we do not foresee an acceleration in growth to a level that would swiftly create inflationary pressures, despite a likely short-term boost from the recent tax policy changes. On a medium-term basis, however, we do have concerns that the potential risks to this late economic-cycle expansion are increasing, among them trade frictions, deteriorating fiscal conditions and overall political uncertainty. The transition of leadership at the US Federal Reserve (Fed) has been smoothly handled so far, and we expect the Fed to continue its data-dependent path on monetary policy as it did during its March 21 meeting, when it raised interest rates 25 basis points. But the new Fed chair, Jay Powell, has taken

stewardship of a very different economy than the one faced by his predecessors. We believe it is important to remember the possibility that the path he is inclined to pursue could be equally distinct.

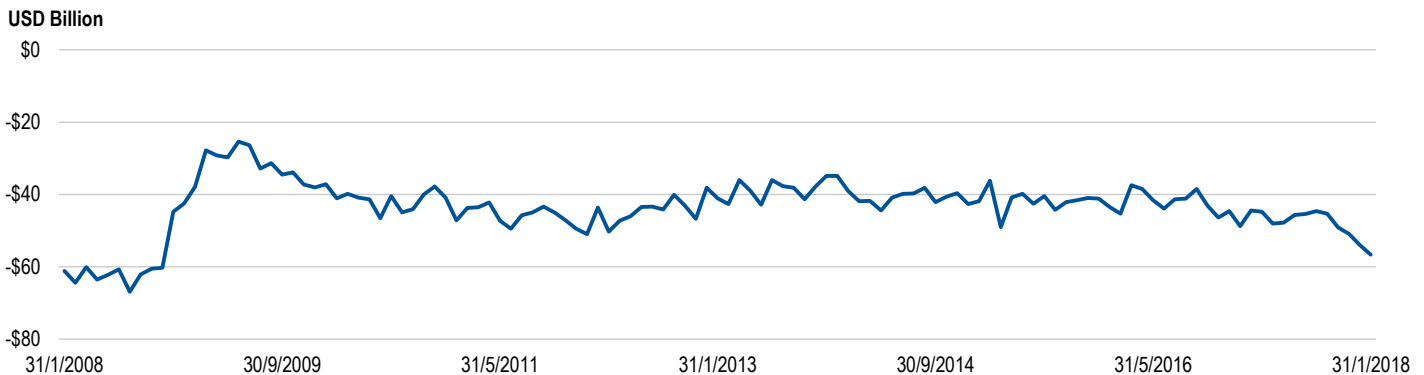
The Trump administration's economic policies took a more protectionist turn in early March, after the formal introduction of tariffs of 25% and 10%, respectively, on steel and aluminum imports into the United States. The measures led other countries to threaten retaliatory measures, though neighbors Canada and Mexico were granted exemptions to allow negotiations on revising the North American Free Trade Agreement (NAFTA) to continue. The decision to press ahead with the measures appeared to trigger the resignation of President Trump's top economic adviser, Gary Cohn, removing one of the more moderate voices on trade from the president's team. It also drew criticism from many leading Republicans. However, in a change from their traditional hawkish stance on government spending, Republicans helped to vote through a deal on the federal budget containing additional and largely unfunded expenditures of around US\$300 billion over the next two years. In the wake of the tax cut package passed at the end of 2017, the spending increases looked set to push the fiscal deficit to well over US\$1 trillion in 2019.

Data continued to point to a solid first quarter for the US economy, with growth powered primarily by consumers, but a few potential headwinds from other factors. Though household

## US Trade Deficit Largest Since 2008

### Exhibit 1: US Trade Deficit, Monthly

Billions of USD, Seasonally Adjusted  
January 2008–January 2018



Source: FactSet, US Census Bureau.

spending appeared to lose a little momentum in January, the effects of the recent modest tax cuts for individuals helped drive up incomes and savings, a positive sign for the near-term economic outlook. Measures of confidence among consumers remained elevated. One leading survey for February climbed to its highest level since 2000, signifying recent stock market volatility had done little to dent optimism. Similarly, business sentiment indicators covering the same month maintained their robust tone. Purchasing managers' indexes (PMIs) from the Institute for Supply Management highlighted strength in certain gauges of orders across both services and manufacturing.

However, as in the previous quarter, trade seemed likely to weigh on growth. January showed a widening of the trade deficit to its largest level since 2008 at US\$56.6 billion. Additionally, trade with China—a key focus for the Trump administration—registered a US\$35.5 billion deficit, the most in more than two years. Historically, the first gross domestic product reading of the year has often somewhat misleadingly implied a slowing of the US economy's momentum, a pattern thought to be caused by as yet unexplained statistical problems.

February's labor market report contained conflicting signals on payroll growth and wages. Payrolls rose by 313,000, well ahead of consensus expectations and the most jobs added in a month since mid-2016, while revisions added another 54,000 positions to the totals for previous months. Also notable was a 0.3% rise in the labor force participation rate, suggesting some untapped reserves of workers were re-entering the labor market, a welcome offset to

the tight employment conditions. But after January's wage growth of 2.9% year-on-year had raised concerns about gathering inflationary pressures—and sparked extreme volatility in stock markets—the latest update on average hourly earnings soothed such fears. At 2.6%, wage gains were lower than expected, and the previous month's figure was revised down to 2.8%. The latest update of the other key signal on inflation—the core personal consumption expenditures price index—was unchanged at 1.5% year-on-year in January, despite a 0.3% rise in the monthly data.

US Treasuries continued their weak start to the year. The release of minutes from the Fed's January meeting heightened speculation that US monetary policy might be tightened at a quicker pace than previously indicated by policymakers. As a result, yields on 10-year Treasuries moved up to their highest level in four years, close to the 3% threshold seen as significant by many market participants. Relatively hawkish comments from Fed Chair Powell added to the pressure on Treasuries. The heightened expectations on interest rates also provided support for the US dollar, which halted a previous run of three consecutive monthly declines to finish higher against other major currencies over February as a whole.



### Global Economy Maintains Cyclical Upturn, but Has Yet to Produce Meaningful Inflation

Toward the end of February, China's Communist Party unveiled proposals to remove the existing two-term limit for the country's leaders, thereby potentially allowing President Xi Jinping to remain in power indefinitely. President Xi—who is also general secretary of the Communist Party and head of the country's armed forces—has increasingly asserted his political dominance since coming to power in 2012, and a far-reaching anti-corruption campaign has helped to enhance his authority.

“ We see the US economy as maintaining its current path of respectable but not overly robust growth. ”

## “ The lack of any plurality of opinion when managing China’s complex economic and social agenda could mean a more volatile backdrop going forward. ”

With the headlines dominated by speculation about US trade policy, the apparent ending of the formal rotation of China’s leadership perhaps attracted less scrutiny in the Western media than it otherwise might have. However, we believe the move is highly significant and increases the risks of a policy mis-step and instability in China in coming years. Among the senior echelons of the Chinese leadership, the chances of any opposing viewpoint to President Xi’s being voiced or tolerated appear remote, effectively leaving the country’s policies to be shaped by the beliefs and decisions of one man. That is not to say we anticipate the world’s second-largest economy is inevitably heading toward a crisis, but rather that the lack of any plurality of opinion when managing China’s complex economic and social agenda could mean a more volatile backdrop going forward.

Elsewhere in Asia, the Japanese yen climbed to its highest level against the US dollar since its sharp decline in late 2016, following the US presidential election. By early March, its rise against the US currency since the start of 2018 measured more than 6%. One of the reasons for the yen’s latest bout of strength was testimony from Bank of Japan (BOJ) Governor Haruhiko Kuroda, in which he appeared to hint that policymakers would consider ending the BOJ’s quantitative easing (QE) program in 2019. Closer examination of his remarks revealed a major caveat: that any potential exit discussion was conditional on inflation reaching the BOJ’s target of 2%. While the Japanese economy has shown signs of progress in shaking off deflation that has lasted for decades, the latest inflation figures covering January revealed an annual rate of only 0.4% once food and energy prices had been stripped out. The yen’s recent rise is likely to exert a dampening effect on prices, as well as provide a headwind for Japanese exporters. With a significant majority of the BOJ’s policymakers still viewing the risks to its inflation forecasts as tilted to the downside, there seemed little prospect of a normalization of monetary policy for some considerable time yet.

Globally, the economic picture remains positive, in our view, with expansion on track across all the major regions. This outlook could be threatened if the tariffs adopted by President Trump spark a full-scale trade war, although we see this as a low-probability scenario. More likely is a continuation of the current cyclical upturn in growth, with inflation lagging due to structural forces like demographics and technology. Until stronger evidence emerges that demand has increased sufficiently to create greater pricing pressures, we think most central banks will be content to monitor developments in their respective economies, rather than look to get ahead of them.

### Japanese Yen Starts 2018 Strongly

Exhibit 2: Japanese Yen vs. US Dollar

1 January 2016–16 March 2018

USD/JPY Price



Source: FactSet.



### ECB Adjusts Messaging, Though Likely to Maintain Dovish Stance for Some Time

Growth indicators for the eurozone dipped slightly in February, the first sign of a pause in momentum for many months. A leading PMI covering both manufacturing and services fell back from the 12-year high reached in January, but the survey continued to signal an elevated level of expansion. The report indicated the leading economies of Germany and France registered the strongest measures of output growth in the region, despite falling to three- and five-month lows, respectively. Other data showed headline inflation remaining soft, with February’s annual rate of 1.2% the weakest since the end of 2016. So far this year, the fading effects of previous energy price increases have slowed the headline rate, as widely predicted. February’s figures also featured a similar trend in food prices. However, core inflation remained at 1%, with some signs of greater pricing pressures on services and non-energy industrial goods.

At its otherwise relatively uneventful March meeting, the European Central Bank (ECB) acknowledged the extent of the eurozone's economic recovery, tweaking its statement by dropping a commitment to expand its QE program if necessary. The central bank's latest set of forecasts contained limited changes to previous projections, with an upgrade of 0.1%, to 2.4%, for its 2018 growth forecast, and a similar reduction in its 2019 inflation estimate, to 1.4%. Its longer-term 2020 forecast for inflation remained unchanged at 1.7%, well below the ECB's target of around 2%.

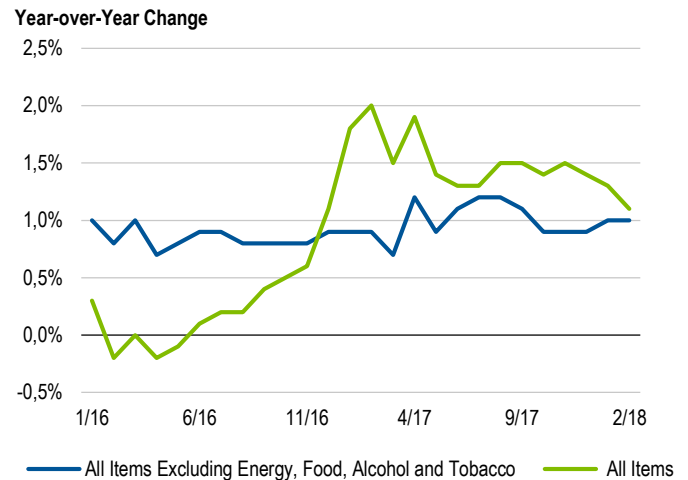
**“ We wouldn't be surprised to see an ECB decision this summer to extend QE beyond the current September commitment, perhaps with a greater focus on corporate bonds. ”**

While we think it unwise to place too much emphasis on a single month's data, we believe the slight dip in growth indicators in February could signal that the eurozone is approaching its maximum potential rate of expansion. Given the strength of the activity, the ECB's removal of an easing bias from its messaging was not surprising. However, our view remains that any major announcement from the central bank on its QE program could be some months off, although its stance will continue to be data-dependent. With the ECB's forecasts still suggesting only a very gradual upward path for inflation in coming years, we would not be surprised to see a decision in the summer to extend QE beyond the current commitment of September, perhaps with a greater focus on corporate bonds.

As the two sides in the Brexit negotiations remained at odds over numerous key issues, other political developments saw the Italian election at the beginning of March produce the inconclusive outcome that had been widely expected. The anti-establishment Five Star Movement won the largest share of the vote, around a third, raising the possibility of it seeking a coalition government with parties on the left of the political spectrum. The incumbent center-left Democratic Party performed poorly, prompting the resignation of its leader, Matteo Renzi, who had opposed any potential agreement with Five Star. The other main populist party, the right-wing League, did better than expected in winning over

## Eurozone Headline Inflation Continues to Weaken

**Exhibit 3: Eurozone Annual Headline Inflation, Monthly**  
January 2016–February 2018



Source: FactSet, Eurostat.

conservative voters, surpassing former Premier Silvio Berlusconi's party. Perhaps the election's most striking feature was the majority of Italians voting for parties whose views on the country's membership in the European Union ranged from lukewarm to decidedly euroskeptic. Although an alliance between Five Star and the League seemed a remote possibility, a period of prolonged political uncertainty during the coalition negotiations—and possibly beyond, if the resulting government proved unstable—looked almost inevitable.

Contrasting news came from Germany, where the members of the Social Democratic Party voted in favor of a coalition with Chancellor Angela Merkel's center-right group, finally allowing a government to be formed five months after the country's election. Though set for her fourth and likely final term in office, Chancellor Merkel's political capital appeared somewhat diminished by the governing parties' poor showing in last year's vote—which saw the right-wing Alternative for Germany become the third-largest parliamentary party—as well as the collapse of her subsequent attempts to form a coalition with other partners. One possible effect of her troubles could be to lessen Germany's pre-eminent position in the eurozone, which in the past has allowed Chancellor Merkel to dampen any moves toward greater integration among member states, due to domestic political sensitivities.

## EUROLAND MACROECONOMIC DATA

### FINAL OUTPUT

Gross Domestic Product (GDP) <sup>1</sup>	1Q17	2Q17	3Q17	4Q17
GDP, Y/Y (%)	2.1	2.4	2.7	2.7
Private Consumption, Y/Y (%)	1.6	1.9	1.9	1.5
Gross Fixed Capital Formation, Y/Y (%)	4.1	3.4	2.4	2.5

### ECONOMIC INPUTS<sup>1</sup>

	Oct 17	Nov 17	Dec 17	Jan 18
Retail Sales, Y/Y (%)	0.3	3.7	2.1	2.3
Unemployment Rate (%)	8.8	8.7	8.6	8.6
Industrial Production, Y/Y (%)	3.9	3.7	5.2	-

### INFLATION & WAGE PRESSURE

Inflation Indicators <sup>1</sup>	Nov 17	Dec 17	Jan 18	Feb 18
Consumer Price Index (CPI), Y/Y (%)	1.5	1.4	1.3	1.2
Core CPI, Y/Y (%)	0.9	0.9	1.0	1.0

### FINANCIAL MARKETS

	Nov 17	Dec 17	Jan 18	Feb 18
Dow Jones EURO STOXX 50 Price Index EUR, Trailing P/E Ratio <sup>2</sup>	18.65	16.23	16.72	15.93
ECB Refinance Rate (%) <sup>3</sup>	0.00	0.00	0.00	0.00
10-Year Yield—German Bunds (%) <sup>2</sup>	0.37	0.43	0.70	0.66

### BALANCE OF PAYMENTS<sup>1,3</sup>

Trade Balance	Sep 17	Oct 17	Nov 17	Dec 17
Billion Euro	25.18	19.05	25.65	25.41

Current Account Balance	1Q17	2Q17	3Q17	4Q17
% GDP	2.6	2.5	4.6	4.3

## JAPAN MACROECONOMIC DATA

### FINAL OUTPUT

Gross Domestic Product (GDP) <sup>4</sup>	1Q17	2Q17	3Q17	4Q17
GDP, Q/Q ar (%)	1.9	2.4	2.4	1.6
Private Consumption, Q/Q ar (%)	2.1	3.3	1.0	2.4
Fixed Capital Formation, Q/Q ar (%)	0.7	4.9	4.2	4.2

### ECONOMIC INPUTS

	Oct 17	Nov 17	Dec 17	Jan 18
Unemployment Rate (%) <sup>5</sup>	2.8	2.7	2.7	2.4
Industrial Production, Y/Y (%) <sup>6</sup>	5.9	3.6	4.4	2.7
Tertiary Index, Y/Y (%) <sup>6</sup>	0.8	1.5	1.3	1.6

Corporate Activities	1Q17	2Q17	3Q17	4Q17
Corporate Profit Growth (%) <sup>7</sup>	26.6	22.6	5.5	0.9
Tankan Quarterly Survey (Index Level) <sup>8</sup>	12	17	22	25

### INFLATION

Inflation Indicators <sup>5</sup>	Oct 17	Nov 17	Dec 17	Jan 18
Consumer Price Index (CPI), Y/Y (%)	0.2	0.6	1.0	1.4
CPI ex Fresh Food, Y/Y (%)	0.8	0.9	0.9	0.9

### FINANCIAL MARKETS<sup>2</sup>

	Nov 17	Dec 17	Jan 18	Feb 18
Nikkei 225, Trailing P/E Ratio	19.4	16.7	16.9	16.2
3-Month Yield—JGBs (%)	-0.201	-0.162	-0.160	-0.198
10-Year Yield—JGBs (%)	0.039	0.048	0.085	0.053

### BALANCE OF PAYMENTS

Monthly Trade Balance <sup>7</sup>	Oct 17	Nov 17	Dec 17	Jan 18
Billion Yen	430	181	539	-667

Current Account Balance <sup>9</sup>	1Q17	2Q17	3Q17	4Q17
% GDP	3.8	3.8	4.0	4.0

Abbreviations: Q/Q ar: Quarter-over-quarter annualized rate. Y/Y: Year-over-year.

1. Source: © European Union 1995–2018.

2. Source: Bloomberg. P/E ratios of Dow Jones EURO STOXX 50 Price Index and Nikkei-225 Stock Average as calculated by Bloomberg.

3. Source: European Central Bank.

4. Source: Economic and Social Research Institute, Cabinet Office, Government of Japan.

5. Source: Ministry of Internal Affairs and Communications, Japan.

6. Source: Ministry of Economy, Trade and Industry, Japan.

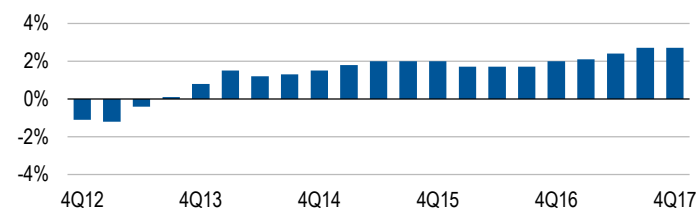
7. Source: Ministry of Finance, Japan.

8. Source: Bank of Japan.

9. Source: Bloomberg Indexes.

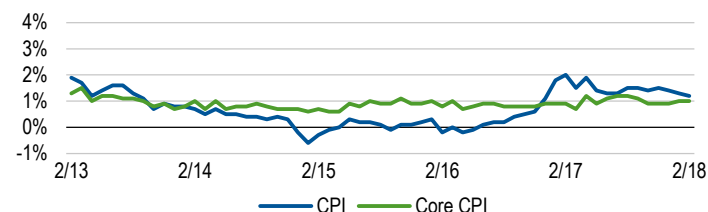
Past performance does not guarantee future results.

## Eurozone Real GDP, Y/Y



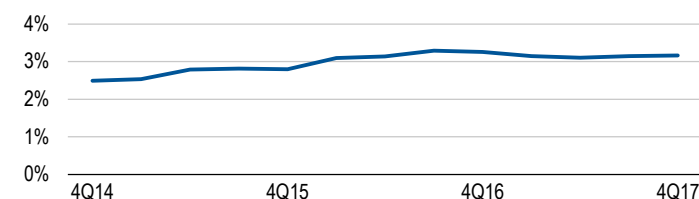
Source: © European Union 1995–2017, as at December 2017.

## Consumer Price Index, Y/Y



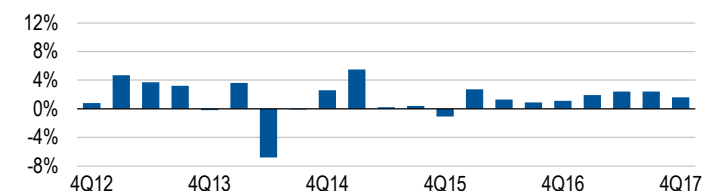
Source: © European Union 1995–2017, as at February 2018.

## External Trade Balance, GDP



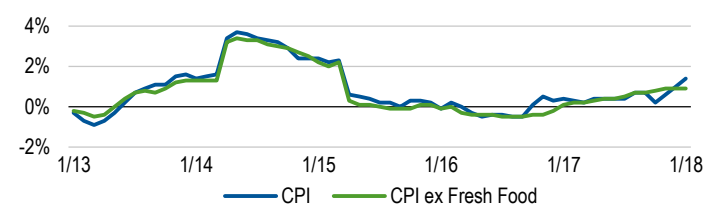
Source: © European Union 1995–2017, as at December 31, 2017.

## Japan Real GDP, Q/Q ar



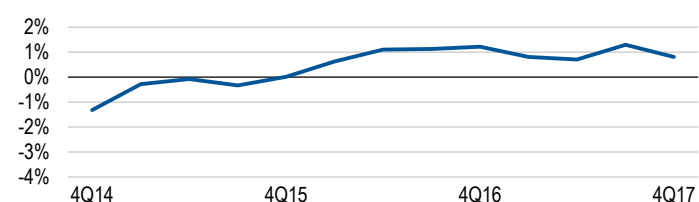
Source: ESRI, Cabinet Office, Government of Japan, as at December 2017.

## Consumer Price Index, Y/Y



Source: Ministry of Internal Affairs and Communications, Japan, as at January 2018.

## Visible Trade Balance, GDP



Source: Ministry of Finance, Japan and Economic and Social Research Institute, Cabinet Office, Government of Japan, as at December 31, 2017.

## US MACROECONOMIC DATA

### FINAL OUTPUT

Gross Domestic Product (GDP) <sup>2</sup>	3Q17	4Q17	1Q18E <sup>1</sup>	2Q18E <sup>1</sup>
Q/Q ar (%)	3.2	2.5	2.7	2.7

### ECONOMIC INPUTS

#### CONSUMPTION/FINAL DEMAND

Income/Savings <sup>2</sup>	Oct 17	Nov 17	Dec 17	Jan 18
Consumer Spending, Y/Y (%)	4.3	4.7	4.5	4.4
Personal Income, Y/Y (%)	3.5	4.0	4.3	3.8
Savings Rate (%)	3.0	2.6	2.5	3.2

#### Employment

	Nov 17	Dec 17	Jan 18	Feb 18
Unemployment Rate (%) <sup>3</sup>	4.1	4.1	4.1	4.1
Participation Rate (%) <sup>3</sup>	62.7	62.7	62.7	63.0
Nonfarm Payrolls (in Thousands) <sup>3</sup>	216	175	239	313
Jobless Claims, 4-Wk Average (in Thousands) <sup>4</sup>	242	242	235	221

#### Housing<sup>5</sup>

	Oct 17	Nov 17	Dec 17	Jan 18
Existing Home Sales (in Millions)	5.50	5.72	5.56	5.38
Y/Y Change (%)	-0.9	2.7	0.7	-4.8

### INVESTMENT

Corporate Earnings <sup>6, 11</sup>	3Q17	4Q17	1Q18E	2Q18E
Earnings, Y/Y (%)	7.8	16.1	16.8	19.5

#### Production & Utilization<sup>7</sup>

	Oct 17	Nov 17	Dec 17	Jan 18
Industrial Production, Y/Y (%)	3.3	3.8	3.4	3.7
Capacity Utilization (%)	77.3	77.5	77.7	77.5

Nonresidential Fixed Investment <sup>2</sup>	1Q17	2Q17	3Q17	4Q17
Y/Y (%)	3.5	4.3	4.6	6.3

### INFLATION & PRODUCTIVITY

#### Inflation Indicators

	Nov 17	Dec 17	Jan 18	Feb 18
Personal Consumption Expenditure (PCE), Y/Y (%) <sup>2</sup>	1.7	1.7	1.7	-
Core PCE, Y/Y (%) <sup>2</sup>	1.5	1.5	1.5	-
Consumer Price Index (CPI), Y/Y (%) <sup>2</sup>	2.2	2.1	2.1	2.2
Core CPI, Y/Y (%) <sup>3</sup>	1.7	1.8	1.8	1.8
Producer Price Index (PPI), Y/Y (%) <sup>3</sup>	4.3	3.3	3.0	2.7
Core Producer Prices, Y/Y (%) <sup>3</sup>	2.2	2.0	1.9	1.9

#### Productivity<sup>3</sup>

	1Q17	2Q17	3Q17	4Q17
Productivity, Q/Q ar (%)	0.2	1.7	2.6	0.0
Unit Labor Costs, Q/Q ar (%)	4.8	-1.2	1.0	2.5

### FINANCIAL MARKETS

Valuation	Jan 18	Feb 18	Mar 18E	Apr 18E
P/E S&P 500 <sup>6</sup>	22.82	21.91	-	-
Fed Funds Rate <sup>7, 8</sup>	1.50	1.50	1.50	1.67

### BALANCE OF PAYMENTS

US Monthly Trade Deficit <sup>2, 9</sup>	Oct 17	Nov 17	Dec 17	Jan 18
Billion USD	-49.1	-50.9	-53.9	-56.6

#### US Current Account Deficit

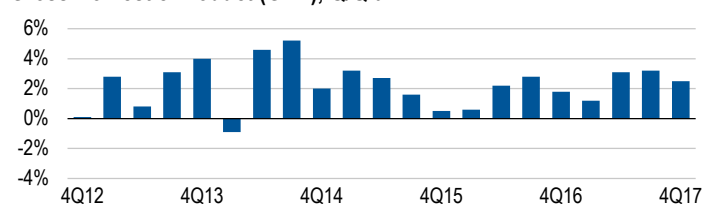
	4Q16	1Q17	2Q17	3Q17
Quarterly (in USD Billion) <sup>2</sup>	-114.0	-113.5	-124.4	-100.6
Annualized (% GDP) <sup>10</sup>	-2.4	-2.3	-2.4	-2.3

Abbreviations: Q/Q ar: Quarter-over-quarter annualized rate. Y/Y: Year-over-year. E: Estimate.

- Source: Bloomberg Economic Forecasts as at 28/2/18.
- Source: US Bureau of Economic Analysis.
- Source: US Bureau of Labor Statistics.
- Source: US Department of Labor.
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- Source: Standard and Poor's.
- Source: US Federal Reserve. At the 21/3/18 meeting the US Federal Reserve raised the main US interest rate to "a target rate" between 1.50% and 1.75%.
- Source: Chicago Board of Trade (30-Day Federal Funds Futures Rate for March 2018 and April 2018), as at 14/3/18.
- Source: US Census Bureau.
- Source: Bloomberg Indexes.
- Source: Bloomberg calculations are share-weighted y/y. Estimates as of 3/14/18.

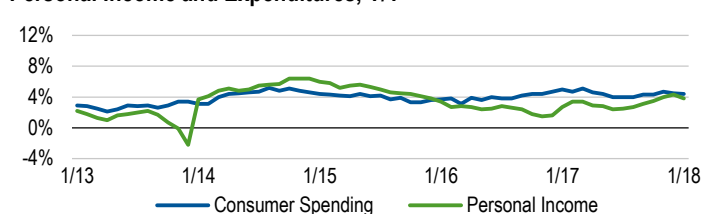
Past performance does not guarantee future results.

## Gross Domestic Product (GDP), Q/Q ar



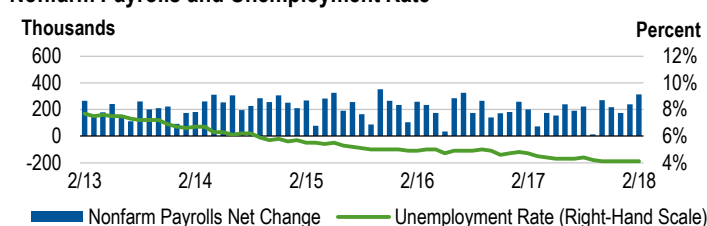
Source: US Bureau of Economic Analysis, as at December 2017.

## Personal Income and Expenditures, Y/Y



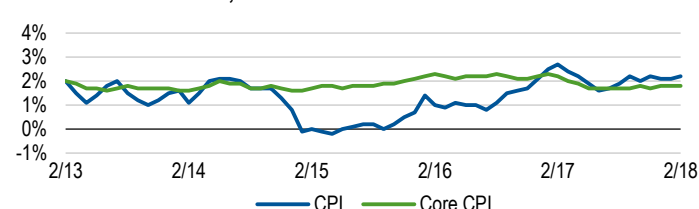
Source: US Bureau of Economic Analysis, as at January 2018.

## Nonfarm Payrolls and Unemployment Rate



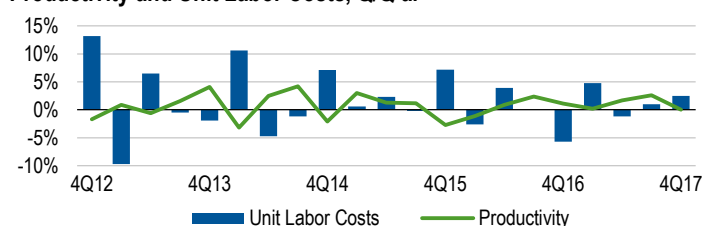
Source: US Bureau of Labor Statistics, as at February 2018. All figures seasonally adjusted.

## Consumer Price Index, Y/Y



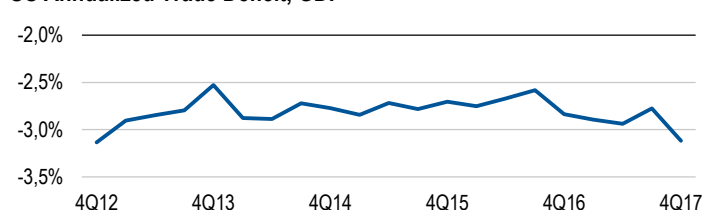
Source: US Bureau of Labor Statistics, as at February 2018.

## Productivity and Unit Labor Costs, Q/Q ar



Source: US Bureau of Labor Statistics, as of December 2017.

## US Annualized Trade Deficit, GDP



Source: US Census Bureau and US Bureau of Economic Analysis, as at December 2017.

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