THE MACRO REPORT | OCTOBER 2016

Signs of policy regime change

At the end of the third quarter, the global macro picture looked a bit better across quite a wide range of countries, both developed and emerging. While we do not view this as a fundamental change of direction, the global economy seems to be moving to the top of the recent range of economic growth, as our Global GDP Nowcast shows. While we see no reason to expect the economy will break out into a new, stronger growth trajectory, it is better to be at the top of a range than at the bottom.

Our Global Risk Appetite Index illustrates that, overall, September was a good month for risk assets. But the recent move up in interest rates raises a series of questions. Are we at the end of an era? Are rates about to move up sharply? How much will risk assets suffer once the paradigm shifts? In what follows, we explore these questions in the context of potential policy regime change underway in the United States, the United Kingdom, and Japan.

THIS MONTH

The end of unlimited support?

Stopping to think about Brexit

Japan on the helipad

The end of unlimited support?

Global central banks are beginning to talk about the limits of policy and the need for complementary fiscal measures.

In the short term, markets do not like changes in the monetary policy regime. Indeed, even the possibility of such change can inflict serious losses. The best recent example of this was the “taper tantrum” in the late spring of 2013, when the mere discussion of an end to U.S. quantitative easing (QE) produced major losses in emerging and other risky markets. So the short-term risks of a policy change are certainly present.

Central banks contemplate the limits of policy

At a deeper level, it has become clear that something is changing in how central banks are considering their policy decisions. There is a broadening discussion of the adverse effects of negative rates, of limits to monetary policy, and of the need for complementary policy actions by governments. In a sense, we seem to be closing the chapter on the era of unlimited support from central banks and only from central banks. As the contours of the changing environment become clear, we should expect some hiccups in the markets.

But we do not believe investors should overestimate these changes. First, the global growth outlook remains just okay. It is hard to see real upside growth surprises anywhere in the developed world, and while some of China’s short-run indicators have improved we think the risks in China are clearly to the downside.

Secondly, central banks are not necessarily making radical changes. If the Fed really does hike rates in December, for example, it will likely be on a slow pace of 25 basis points per year. And the dynamic with the dollar remains in play: When the prospects for monetary policy divergence rise, the dollar appreciates, undercutting the need for the Fed to hike.

Mixing policy change with fiscal change

The one major development to consider now is the possibility of a change in the mix of monetary and fiscal policy. People are talking about this in the United States, but any fiscal impulse here will likely be small. In the United Kingdom and Japan, however, the possibilities are greater. The Bank of Japan’s (BoJ’s) latest moves have opened the door for the government to act. In the UK, the new conservative government clearly has embarked on a path of relaxing its self-imposed fiscal constraints.

Consequently, then, the environment for risk is changing. There is uncertainty over the U.S. presidential election — and the increasing potential for a Democratic sweep of the presidency and congressional elections. There is also market uncertainty with regard to the future policies of the Fed, the ECB, and the BoJ. In general, once these short-term uncertainties pass, we think the environment is likely to remain benign for risky assets.

Stopping to think about Brexit

The enactment of U.K. political priorities may exact a high economic cost, but a new approach to macro policy may open the door to meaningful fiscal measures.

In the United Kingdom, we are learning a little more about how the government views Brexit options. Prime Minister Theresa May has said that Article 50 is likely to be triggered by the end of first quarter of 2017, which means real progress has been made in clarifying what the government wants to achieve.

U.K. priorities risk high economic costs

The U.K. government has indicated its priorities are to end budgetary contributions to the European Union, to end free movement of people, to restore the supremacy of U.K. over European law, and to end the jurisdiction of the European Court of Justice (ECJ). Giving priority to the ability to restrict immigration and reduce spending on transfers to the European Union means that the government will have to give up any hope of full access to Europe's single market.

This has come a shock to London's financial sector. Loss of "passporting" rights for financial institutions seems to be something the government is willing to risk. The global banks have apparently run to the U.S. government, trying to get U.S. officials to put some pressure on the U.K., which will likely be for naught. But what should we make of these indications from the government?

Political security, economic uncertainty

It's certainly true that the government looks secure. Theresa May is quite popular, and the opposition Labour Party is not inspiring any fear on the part of the government. Labour has just gone through a leadership election and has re-elected Jeremy Corbyn, a leftist who does not generally appeal with the broader electorate. With UKIP (the U.K. Independence Party) eating away at its electoral base and with upcoming changes to the boundaries of Parliamentary constituencies, Labour is shrinking as a political force.

The fact that the economy looks good so far does not mean the vote was costless, and it is by no means clear that the government's position is yet settled. Moreover, the exact tradeoffs that will be required, and that will matter greatly to the longer-term outlook, cannot be known yet. They will depend critically on the attitude of the French and German governments, both of which will be determined by next year's elections. So while the probability of a "hard Brexit" has risen, it is far too early to be confident about what exactly this means.

A new approach to macro policy

The change in government has brought about another important change in economic policy: The new Chancellor has signaled that the old fiscal targets will be dropped and new rules will be put in place that would permit a large expansion in public spending on infrastructure. As one key member of the government is reported to have said: “We can borrow at a zero real rate. Why wouldn’t we?” He went on to say that monetary policy is clearly reaching its limits and a new approach to macro policy was called for.

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We believe the United Kingdom has a more flexible macro policy framework than other advanced countries, and it will be interesting to see in the Chancellor’s Autumn Statement, due in November, more details about what the government has in mind. The guidelines will tell us a lot about the size of any fiscal boost being considered, and also whether it will be limited to infrastructure investment spending. The prospect of a shift in the global approach to macro policy is definitely in the air.

Japan on the helipad

The Bank of Japan's "comprehensive assessment" of policy has led it to clear a path toward potentially radical fiscal change, including the government's use of "helicopter money."

Our current Nowcast for Japan has been improving quite steadily in recent months. While there is a lot of month-to-month volatility in the data flow, and it is hard to reconcile often contradictory releases, the Nowcast methodology allows us to include a wide variety of data points and reveal the underlying story. That story is one of steady improvement, and it is now much easier to agree with the BoJ's assessment that the economy is on a trajectory of moderate recovery.

The real story, however, continues to be inflation, which looks to be dropping further. It is because of this that the BoJ undertook its "comprehensive assessment" of monetary policy, which was behind the important announcements of September 21, 2016. Because Japan is at the leading edge of the G7's struggles with post-financial crisis macro policy, it is worth spending a little time on what the BoJ did.

Reading Japan's "comprehensive assessment"

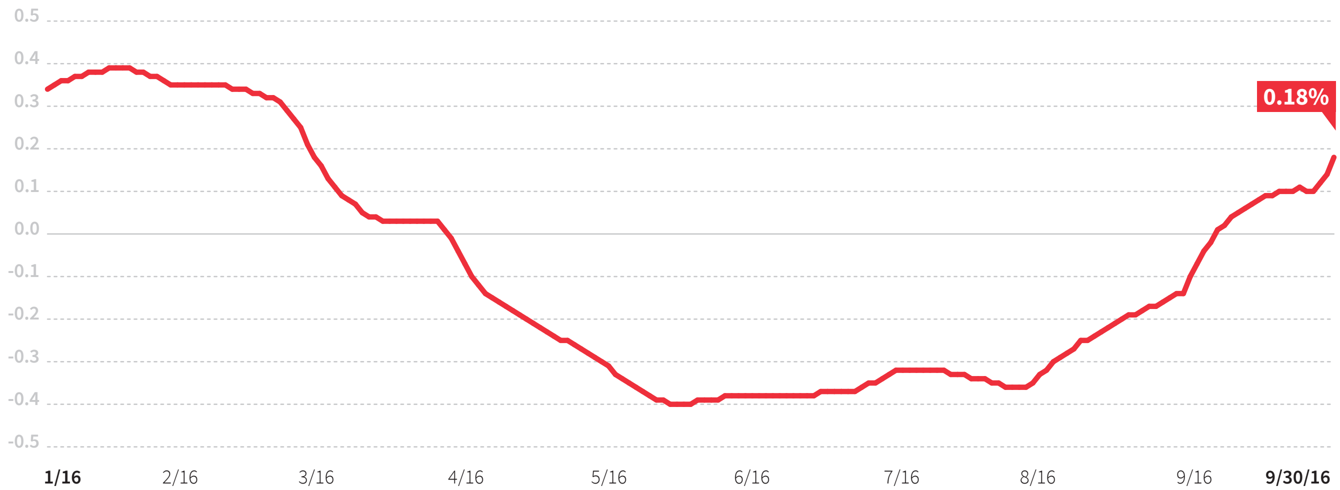
On the day of the meeting itself, the yen rallied quite sharply and almost broke through the psychologically important level of 100 — a reaction to the market's expectations of further expansion in Japan's easing program. Our own expectation was that there would be some expansion of the program to include bonds issued by a variety of public sector institutions. Instead, the BoJ adopted what it calls "Quantitative and Qualitative Monetary Easing [QQE] with Yield Curve Control" in a new attempt to overshoot the inflation target and push inflation expectations decisively upward.

The "yield curve control" piece of this commits the BoJ to keeping the 10-year JGB yield at "more or less its current level, around zero percent." This means abandoning its quantitative JGB purchase targets, since it's hard to know what level of purchases will be necessary to achieve its new objective. The market, however, saw this as a possible end to Japan's easing measures, and thus perhaps even a tightening of policy.

We think this is the wrong way to interpret Japan's move. Instead, we see this as creating the possibility of a substantial policy easing. In the first place, the BoJ has committed to continuing to increase the monetary base. Indeed, it expects its balance sheet to exceed 100% of GDP in one year's time. Secondly, committing to holding 10-year JGB yields around zero is an open door to fiscal relaxation. Recall that back in January 2013, the BoJ and the Japanese government released a joint statement effectively pledging to coordinate efforts to overcome deflation. This new policy allows the government to expand its spending with no impact on JGB markets.

Recent improvement in Japan's economy should not be dismissed

Japan GDP Nowcast



Source: Putnam. Data as of September 30, 2016. We base our proprietary Japan GDP Nowcast on a tailored methodology that captures daily data releases for Japan's most essential growth characteristics. The mix of factors used may change over time as new indicators become available from data sources or if certain factors become more, or less, predictive of economic growth.

Will Japan use the helicopter?

There is every reason to believe this form of quantitative easing would be more effective if the government took up the invitation the BoJ has extended. Until now, QQE has consisted of buying government bonds from the financial sector. The financial sector has taken this money and spent it on other financial assets, boosting asset markets but not doing a lot for the economy as a whole. Higher asset prices do affect the real economy by lowering the cost of capital to the corporate sector and boosting wealth effects on household spending, but these effects have not been particularly large. The most effective form of easing would be helicopter money — directly injecting money into the economy via households. (The central bank could just give every household a specific sum of money and be confident that a lot of this money would be spent. Some would go to paying down debt, but accelerating the pace of deleveraging would have the effect of bringing a recovery forward.)

> "Japan's economy has continued its moderate recovery trend."
>
> **Bank of Japan, September 21, 2016**

Legal, institutional, and political obstacles stand in the way of genuine helicopter money. But providing central bank financing for government spending would generate spending in the economy, even if the government activity being financed was, in some sense, wasteful. Indeed, Keynes pointed out a long time ago that people could be employed to dig holes and fill them in again; after all, they would spend their wages. Direct central bank financing of the government is illegal in many countries, but the BoJ's announcements achieve the same effect without directly funding the government.

For this reason, we see the BoJ's new policy as opening up the possibility of a significantly easier policy stance, if only the government walks through the door that the BoJ has opened.

OCTOBER 2016 | PUTNAM GLOBAL RISK APPETITE INDEX

The Putnam Global Risk Appetite (RA) Index is a proprietary quantitative model that aims to measure investors' willingness to invest in risky assets, including equities, commodities, high-yield bonds, and other spread sectors. With a composite view of risk-appetite signals across a broad mix of asset types, Putnam's RA Index provides a framework for discussing investor preferences and can signal trend changes in broad market sentiment.

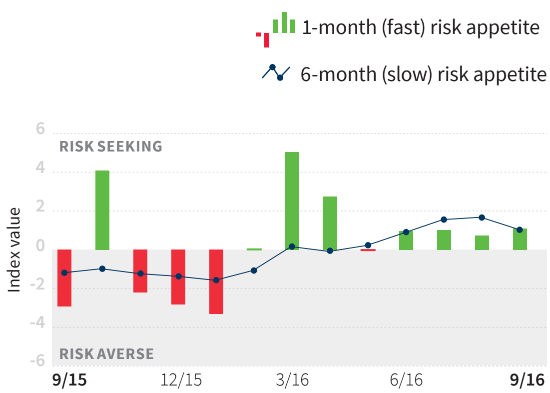
Risk appetite remained positive in September

SHORT-TERM TREND

For much of 2016, and despite volatile events like U.K. voters' decision to exit the European Union, investors have gravitated toward riskier investment types.

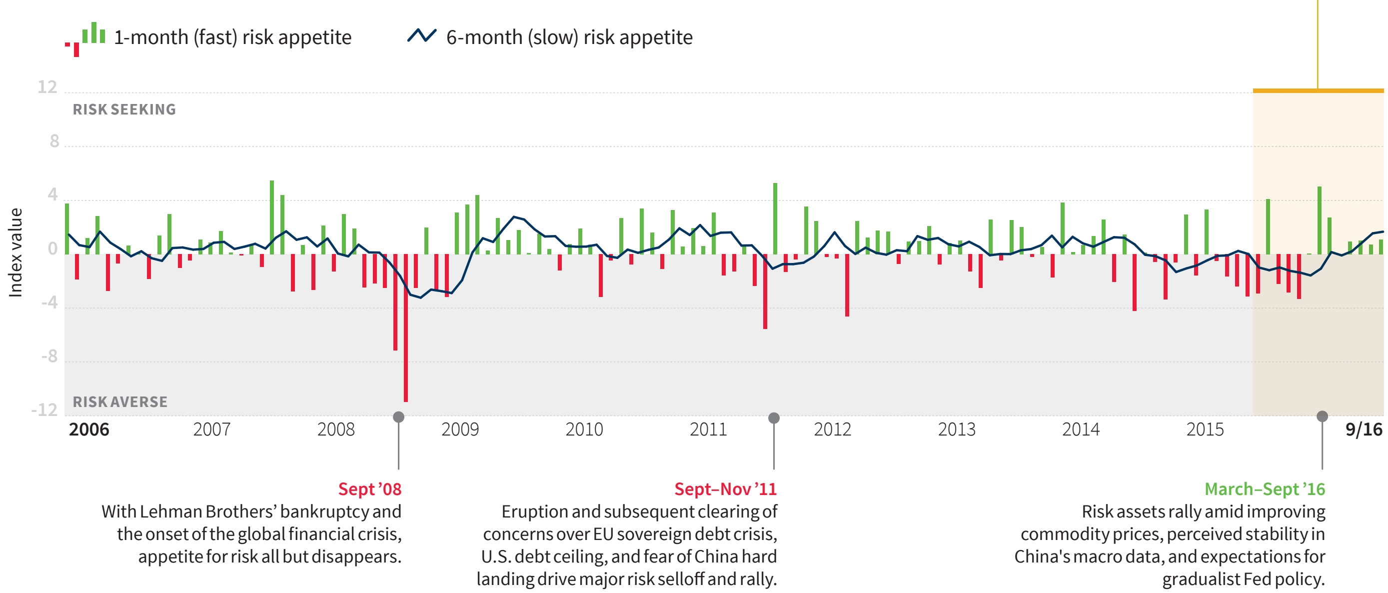
Risk ON OFF

- In September, risk appetite was positive.
- Risk appetite has been positive for four months running.
- If you "sold in May and went away," you missed a summer risk rally.



LONG-TERM CYCLE

This 10-year illustration captures the cyclicality of investors' appetite for risk.



Source: Putnam. Data as of September 30, 2016. To create the Global Risk Appetite Index, we weigh the monthly excess returns of 30 different asset classes over 3-month T-bills relative to the trailing 2-year volatility of each asset class. The higher the excess return and the lower the volatility, the greater the risk appetite; conversely, the lower the excess return and the higher the volatility, the stronger the risk aversion.

OCTOBER 2016 | **PUTNAM GLOBAL GDP NOWCAST**

The Putnam Global GDP Nowcast index is a proprietary GDP-weighted quantitative model that tracks key growth factors across 25 economies. This index and individual country indexes are used as key signals in Putnam's interest-rate and foreign-exchange strategies

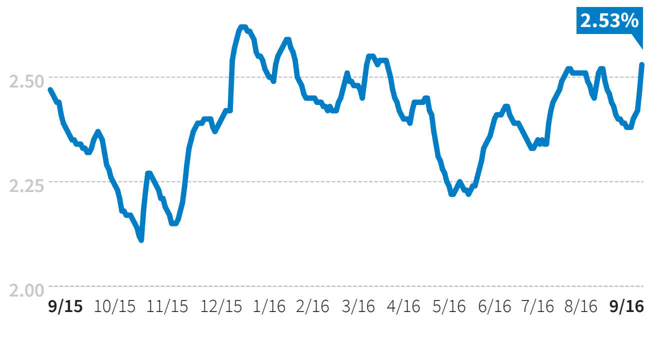
Growth has moved toward the top of its recent range

SHORT-TERM TREND

With a few exceptions — notably, some growth stabilization in China — disappointing growth trends have prolonged the sideways movement of global growth in 2016.

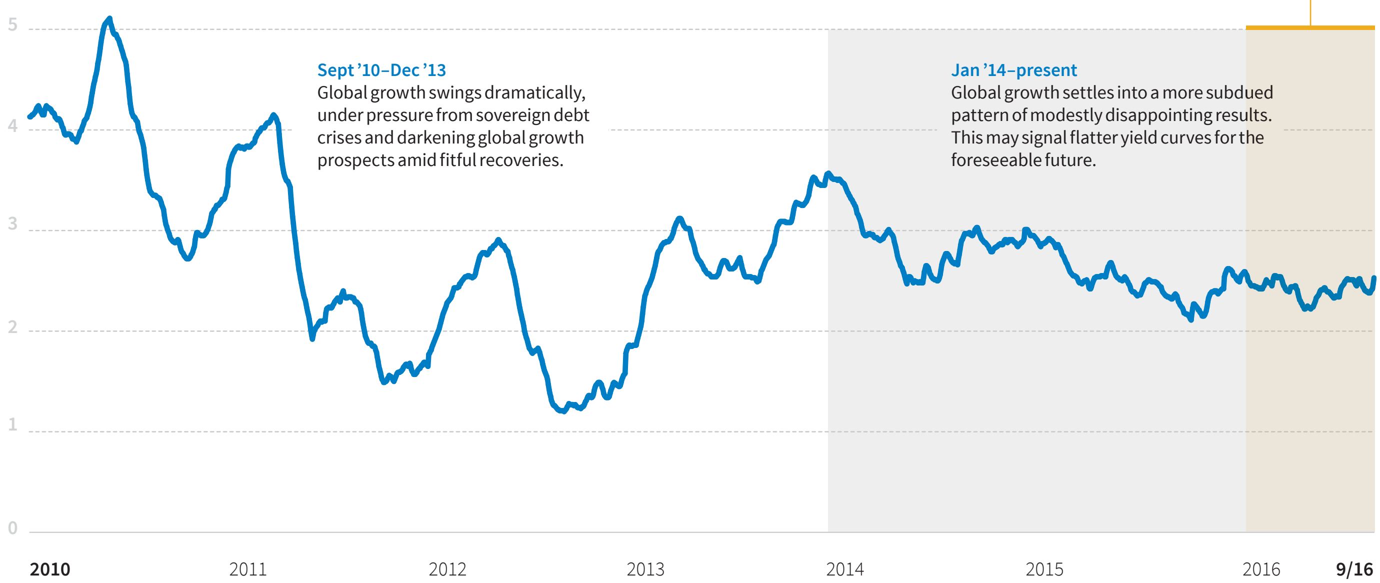
▲ 2.53%

The pace of growth has varied little in 2016, but appears to be testing the top of its recent range



LONG-TERM CYCLE

This six-year illustration captures GDP gyrations since the financial crisis and the low-growth reality of the "new normal."



Source: Putnam. Data as of September 30, 2016. We base our Global GDP Nowcast on a tailored methodology that captures daily data releases for the most essential growth characteristics for each of 25 countries — including purchasing managers index data, industrial production, retail sales data, labor market metrics, real estate price indexes, sentiment indicators, and numerous other factors. The mix of factors used for each market may change over time as new indicators become available from data sources or if certain factors become more, or less, predictive of economic growth.

The Macro Report is written by members of Putnam's Fixed Income team. With backgrounds in applied economics, currency and interest-rate analysis, and sovereign and local bond market dynamics, this group conducts macroeconomic research in support of Putnam's global fixed-income strategies.

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