THE MACRO REPORT | DECEMBER 2016

Beyond belief: Self-perpetuating market stories

Stories that people tell about markets have a way of reinforcing themselves. There are investors who begin to invest because they believe the stories are true. And there are investors who don't necessarily believe the stories, but invest based on the conclusion that other investors may believe them. The dominant tale now — in the United States, at least — is that the market's positive potential has risen because U.S. politics has changed.

Given how long the markets have operated under a grand narrative involving the "new normal," it is hard to imagine that portfolios are well positioned for a world with Donald Trump as the U.S. president. We think that much money has yet to be moved around to respond to the new expectations for U.S. political regime change. This month, we look deeper into the post-election U.S. stock market rally, the evolving landscape of European political risk, and China's continued efforts to maintain control of its economy.

THIS MONTH

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The Trump reflation trade

The market's honeymoon with Trump may not end well if U.S. policies tilt into a protectionist stance.

As of mid-December 2016, we wonder how much further the global reflation trade can go in the absence of more details about the policy priorities of a Trump presidency. Interest rates moved sharply higher after the election and then consolidated, and U.S. equities have roughly followed a similar path. But while U.S. rates have pulled up nominal rates in most of the rest of the world, the equity move has been much less even globally, with U.S. equities generally outperforming. The story that global markets are telling us is that the U.S. outlook has changed, but will the market reprice once more details are known about Trump's agenda? Are markets taking the story of the "growth friendly" Trump too seriously and willfully ignoring his lurking "protectionist" self?

Arguments for caution abound

We remain cautious about those aspects of the Trump campaign that we perceive to be unfriendly to growth, such as ad hoc interventionism, protectionism, and hostility to immigration. There certainly are those who believe that the threats to tear up NAFTA and label China a currency manipulator were just campaign rhetoric that will be abandoned as smoothly and easily as the promise to investigate, prosecute, and jail Hillary Clinton. Politicians say things to get elected, after all, and there's a time-honored tradition of treating campaign promises cavalierly.

But what of trade? It is important to understand that some of the President-elect's economic advisors are non-academics who interpret national income accounting identities, the formulae economics uses for calculating things like GDP and GNP, as proving that imports are harmful to growth. Wilbur Ross, Trump's nominee for Commerce Secretary, recently said: "It's Econ 101 that GDP equals the sum of domestic economic activity plus "net exports," i.e., exports minus imports. Therefore, when we run massive and chronic trade deficits, it weakens our economy."[1] Ross is undeniably a successful businessman, but, clearly, success in business does not require nor confer an understanding of economics.

1 *The Wall Street Journal,* among others, offers a discussion of what's wrong with this statement: http://www.wsj.com/articles/trumps-money-men-1480551496.

Some of Trump's trade advisors have a history working as industry lobbyists, and some of these individuals and the industries they have represented have a big axe to grind with trade. We think investors should be highly cautious about this side of Trump's policy agenda. Adding to this uncertainty is how little we know about the proposed Treasury Secretary Steven Mnuchin. He has said his priority will be tax reform and growth, but we do not know what he thinks about currencies and international trade.

Where Trump seems to stand on trade

Trump himself seems to have believed for a long time that other countries steal growth from the United States. In the mid-1980s, he paid for a full-page advertisement in *The New York Times* that attacked Japan for a currency policy that was, he said, undermining the U.S. economy. Fresher in everyone's minds, of course, is the United Technologies/Carrier "deal." In our view, this is exactly the wrong kind of industrial policy to adopt, as it encourages rent-seeking corporate behavior and challenges the concept of a level playing field for business.

We will have to wait and see how Trump's unexpected telephone call to Taiwan and some recent tweets about China's currency will affect U.S./China relations. These actions certainly point to a different U.S. approach to China. In addition, Trump's tweets about 35% tariffs being imposed on relocating companies' shipments into the United States strongly suggest that caution over the incoming administration's approach to trade is warranted.

Inflationary effects to watch

On the other hand, any protectionist moves would tend to push inflation up and reduce the downward pressure on inflation from an appreciating dollar. While we think protectionism would also be harmful for growth, in the short term the inflationary aspect would probably matter more for interest rates than any impact on growth prospects.

But there is more to come. First, the presidential election result has likely broken the policy logjam in Washington. Second, growth dynamics were improving anyway and inflation risks are already rising, which means Trump comes into power just as the economy is looking relatively strong. Lastly, the global backdrop may come into play in 2017 as well, although this is more likely to be a force keeping interest rates lower, rather than adding to upward pressure. Again, it's important to note that you don't have to believe that the promise of this new world will be realized; you just have to believe that the political shift has changed the probability distribution of outcomes. And how the rest of the world will interact with these new U.S. dynamics will be something to watch closely.

Are markets taking the story of the "growth friendly" Trump too seriously and willfully ignoring his lurking "protectionist" self?

Living with political risk in Europe

Although populist political pressures are strong across Europe, they may not prove strong enough to break EU institutions.

In Europe, we are learning that populist opposition to the status quo is high, particularly with the examples of the recent Italian referendum and the rise of the far-right in France. But we think this opposition is not strong enough to wrest political control of these nations or the European Union; it is only strong enough to be a persistent risk and constraint on the economy. In other words, the risk of eurozone breakup is not trivial, but in the short run we think of it as a nagging headache, not a heart attack.

Austria flirts with nationalism, Italy rejects political reforms

The recent re-run of the Austrian presidential election raised the possibility of a far-right head of state in a European country for the first time since World War II. Opinion polls had suggested the race was too close to call, but Norbert Hofer, politician for Austria's far-right Freedom Party, conceded defeat as early results came in, and looks to have lost by about six percentage points to Alexander Van der Bellen, an economist and member of Austria's Green Party. This is the first time in a while that we have had a pre-election opinion poll error that understated the support for liberal internationalism.

The referendum result in Italy, by contrast, was a resounding rejection of Prime Minister Matteo Renzi's proposed political reforms. The margin was large (practically 60/40), and turnout seems to have been around 70%, much higher than most analysts had expected. This combination left Prime Minister Renzi with no choice but to offer his resignation. For us, the Austrian and Italian developments signal two areas of concern: potential financial shocks that may proceed from political events like Italy's referendum, and the broader dimensions of political risk in Europe.

Italian bank issues overshadowed by bigger political questions

Italy's banks, which remain saddled with massive amounts of non-performing loans, are not likely to send Italy or Europe into a financial crisis, particularly with the ECB's early-December announcement that it will extend its bond-buying support through 2017. More concerning is what happens next in Italian politics. But even there, we imagine that some form of a caretaker government will soon be tasked primarily with passing an electoral law ahead of new elections in late 2017. In the short run, this means that the economic reform agenda, which Renzi had put to one side to focus on the political reforms, will remain sidelined.

Overall, we do not see Italy's referendum result as significantly increasing the chance that the next election will bring a populist, anti-Euro government to power. In particular, we do not believe that the current Italian Parliament will write electoral rules that will allow the populist Five Star party to gain enough seats to form a government on its own. Electorally, the populist vote is split between the left and the right with no unifying figure in sight and little chance of securing a Parliamentary majority.

In France, populism may be held at bay

There are oddly similar dynamics at work in France. Former Prime Minister François Fillon won the conservative primary, beating both former President Nikolas Sarkozy and former PM Alain Juppé. Fillon is more socially conservative than his rivals, but he also has been arguing for more authority to be returned to national governments from the European Union, and he has announced an aggressive set of economic-reform proposals.

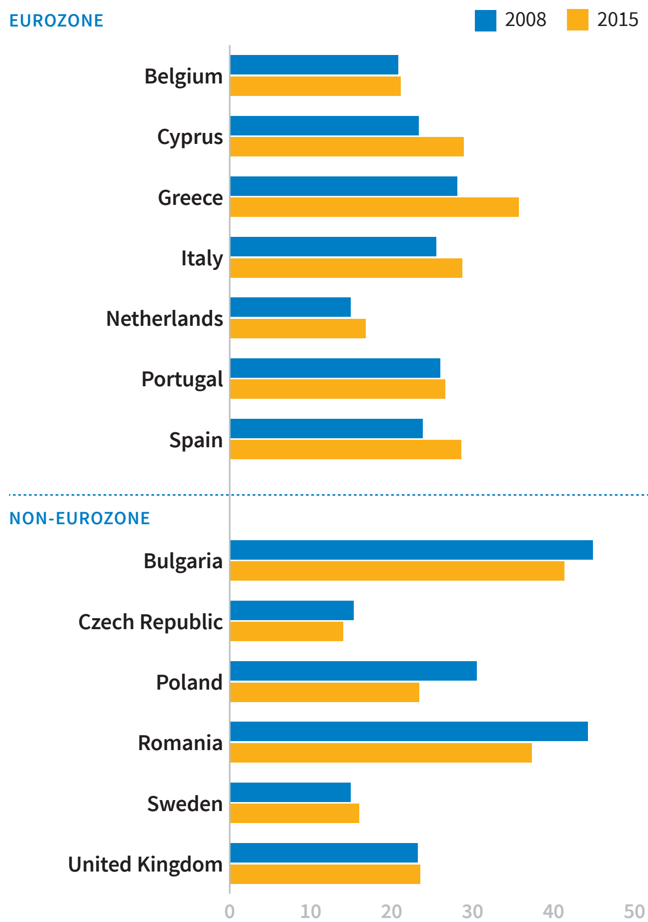
On current polling, the two candidates most likely to advance to the second round of French elections are Fillon and far-right Front National leader Marine Le Pen. A variety of political observers seem confident that Fillon would win a contest with Le Pen quite handily. If this is correct, in 2017 we would see France elect a president with a clear economic reform agenda. On the other hand, President François Hollande's decision not to run for reelection, given his low levels of popularity, opens up the possibility that there may be a compelling candidate from the left, and this could change the race's dynamics.

Meanwhile, we think Le Pen's chances of pulling off a Brexit- or Trump-style upset are small. Even when she is polling well, she does not appear to earn a majority of votes in the second round. Of course, the polls could be wrong, and Le Pen could end up drawing votes unexpectedly in the way Trump did in the Midwestern United States. On the whole, however, market pricing suggests that there will be no major shock from France next spring.

Social exclusion is rising in the eurozone

A defeat for Front National would not be a signal that Europe's populist wave has been reversed or halted, however. Indeed, there are reasons for thinking that the eurozone's socioeconomic developments are worrying. Recent Eurostat data on "social exclusion" — a concept the EU uses to measure vulnerable populations, including the poor, the unemployed, and people who would be in poverty if not for government payments — show social exclusion on the rise. While we might expect to see this in Europe's periphery, it is also true in some countries in Europe's core.

Percentage of population facing social exclusion



"Social exclusion" is defined as people at risk of poverty, plus "persons severely materially deprived," plus persons living in households with "very low work intensity." Source: Eurostat, as of 10/16/16.

It is also fairly clear to us that the trends are different in the eurozone than in the rest of the EU; in other words, there is something about the eurozone that is making economic outcomes worse than in the obvious comparator countries. That "something," we would contend, is the policy framework, which lacks flexibility. This is why the populist movement in Europe is gaining ground and why it names "Brussels" and "globalization" as specific enemies.

The risk of eurozone breakup is not trivial, but in the short run we think of it as a nagging headache, not a heart attack.

Despite populist pressure, European institutions remain robust

In our view, European adherence to the current policy regime will continue to stifle economic performance and raise political risks. In the short run, however, we think it will remain hard to make money from betting against the resilience of European institutions. (Remember the drama over Greece?) European political systems have a way of opting for outcomes that preserve the status quo, even if they are suboptimal economically. Importantly, that is why populist pressure is not likely to disappear.

EM weakness may spread

China continues to adjust its capital controls while political change in Washington, D.C., may signal substantive transformations of China/U.S. relations.

Aside from India, where the government has managed to cause considerable economic disruption in a botched demonetization project,[2] emerging economies appear on the surface to be slightly stronger to us over the previous month. But underneath some of the healthier aggregate data points on emerging markets (EM), we observe that political struggles appear to be building again in Brazil, political tensions remain high in Turkey and South Africa, and capital outflows prompted by Trump's election victory have pushed interest rates up across almost all EM. While the economic effect of higher rates will be partially offset by the drop in exchange rates, we should expect to see at least some EM slowdowns in the coming months. In the short run, however, with China providing mild positive surprises in its data, there has been some resilience in the EM data flow.

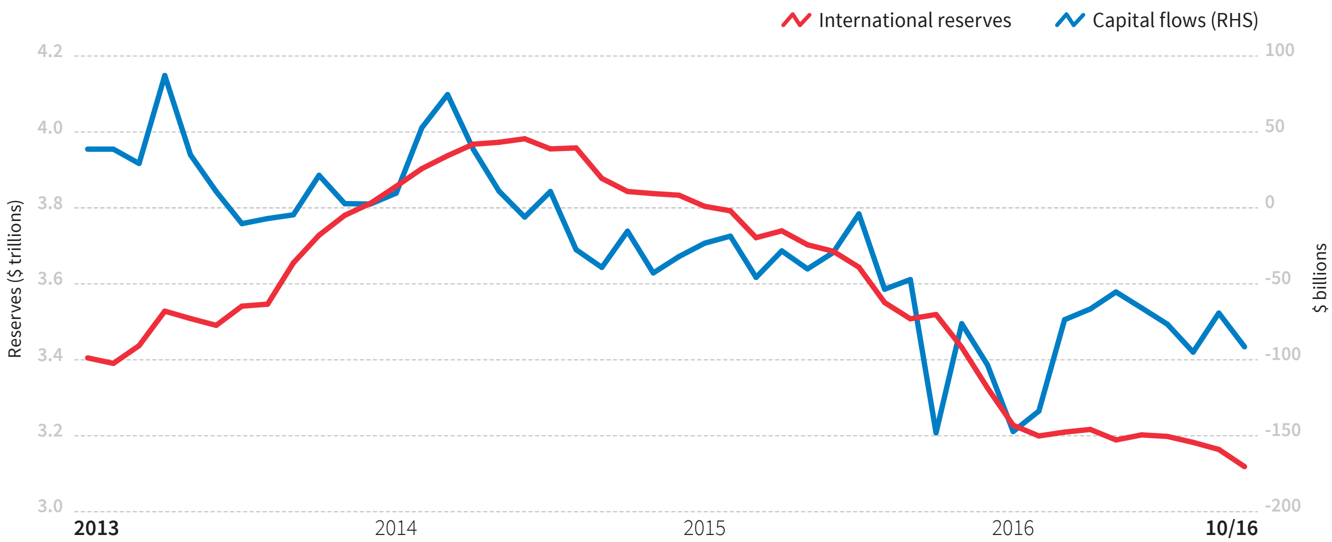
China stays controlled

Although China's economy has been boosted with stimulus, that stimulus is being withdrawn as policymakers work to fine-tune the economy's growth. Overall, we do not think this experimentation will conclude well, but the end does not appear imminent. We do, of course, have the additional uncertainty generated by the U.S. election and Donald Trump's phone call with Taiwanese President Tsai, the motivation for which is unclear. It certainly has grabbed Beijing's attention. Will China be named a currency manipulator? If it is, how will Beijing respond?

At the moment, the yuan is weakening, and the authorities are resisting this, so if there is any currency manipulation, it is focused on keeping the yuan stronger than it would otherwise be. As our accompanying illustration shows, China's foreign reserves position is on the decline and private capital is leaving China fairly quickly, although not at the pace of the late summer and year-end of 2015.

2 The Indian government recently decided to demonetize the two largest currency notes in circulation, the 500 and 1,000 rupee notes, and replace them with new designs. The key to doing this sort of thing well is to ensure there is a plentiful supply of new notes, and to give people lots of time to transfer their old notes into the new ones. The Indian government did neither. In large part, this project was aimed at clamping down on the informal economy, which runs on cash. But cash is a key payment mechanism for the rest of the Indian economy, and the notes in question accounted for about 86% of all cash in circulation. In the short term, the economic costs of this badly designed and executed policy initiative have been estimated to run as high as 2% of GDP.

China's capital flow and reserves



Source: People's Bank of China, November 2016.

However, flows in and out of China are not free. They reflect what the authorities allow to happen — with some leakage, of course, to which all systems of flow controls are susceptible. On the available balance of payments data, net outflows exceeded $200 billion in the third calendar quarter of 2016, and they seem to be continuing thus far in the fourth quarter, albeit at a slightly reduced pace.

Fine-tuning China's capital account

The Chinese authorities continue to tweak their capital-flow controls with a series of small tightening measures. Over the span of a month, they have restricted the use of Bitcoin exchanges to send money overseas, introduced new monitoring of flows through the Shanghai Free Trade Zone, restricted large overseas direct investments, and tightened the ability of onshore companies to loan yuan to offshore subsidiaries. Clearly, China has ample scope to fine-tune the nation's capital account, just as it fine-tunes GDP growth.

Of course, this is all a reflection of domestic economic strains. In our view, if returns to capital within China were attractive, capital would not be leaving. But returns on capital in China cannot be pushed higher because that would restrict credit creation as well as growth, and would impose high costs — probably unbearable ones — on domestic debtors.

We continue to think there is a big problem building in China, particularly in its towering debt, but we also think the authorities have the tools and the determination to keep everything running, if not actually making much progress. At the margin, there is a risk that the yuan will be weaker and growth slower in 2017, perhaps significantly more so than expected.

PUTNAM GLOBAL RISK APPETITE INDEX | DECEMBER 2016

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.

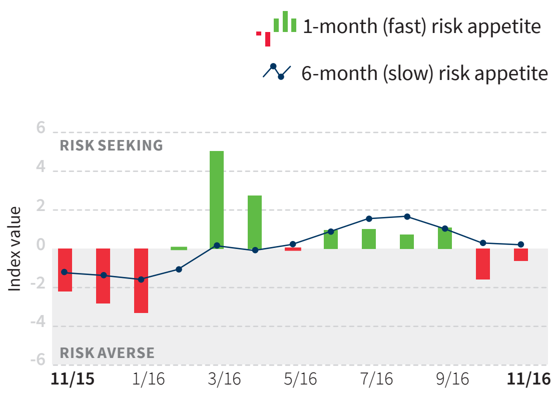
Risk appetite was negative in November

SHORT-TERM TREND

In November 2016, risk appetite was negative overall, despite a rally in U.S. stocks.

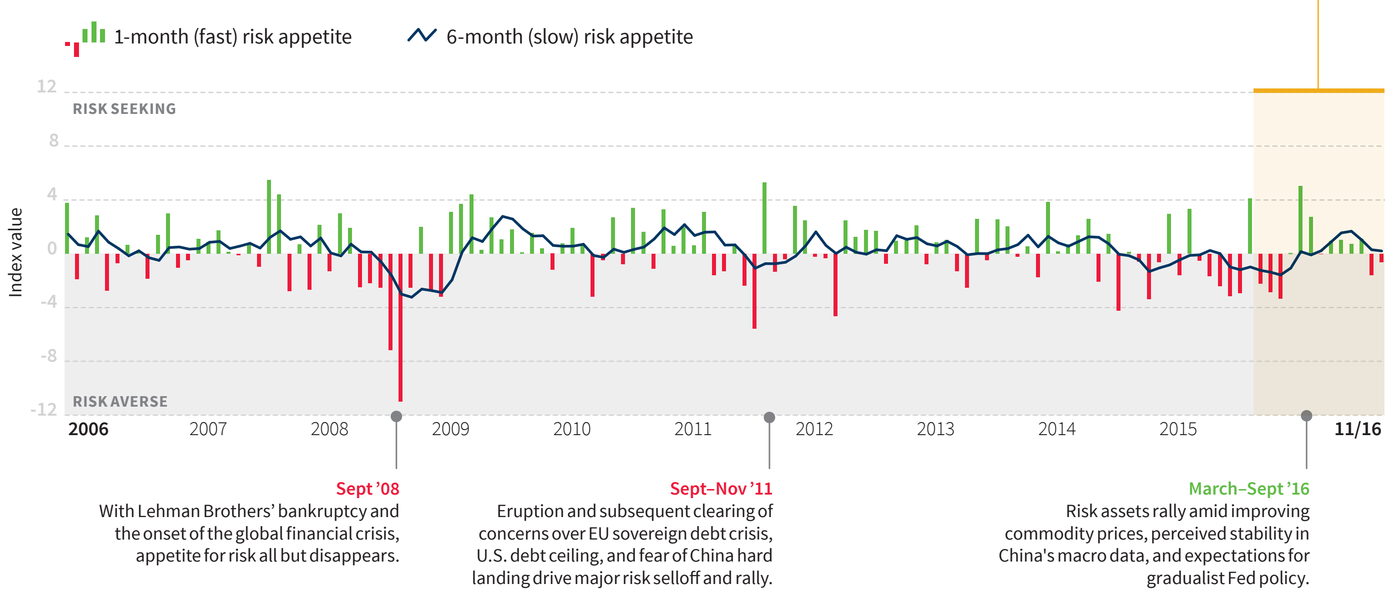
Risk ON OFF

- In November, risk appetite outside the U.S. was negative enough to offset positive risk sentiment for domestically oriented U.S. stocks.
- Poor-performing fixed-income assets included longer-dated U.S. Treasuries.



LONG-TERM CYCLE

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



Source: Putnam. Data as of November 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.

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PUTNAM GLOBAL GDP NOWCAST | DECEMBER 2016

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.

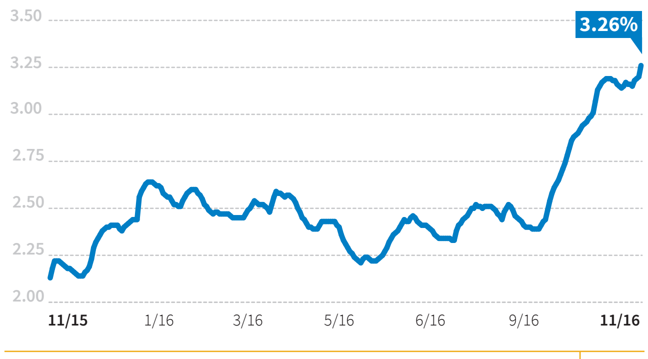
Growth continued to climb above its recent range

SHORT-TERM TREND

Global growth gained in November, mainly due to U.S. data. Europe, the U.K., Japan, and China were all stable, while Russia improved its GDP growth significantly.

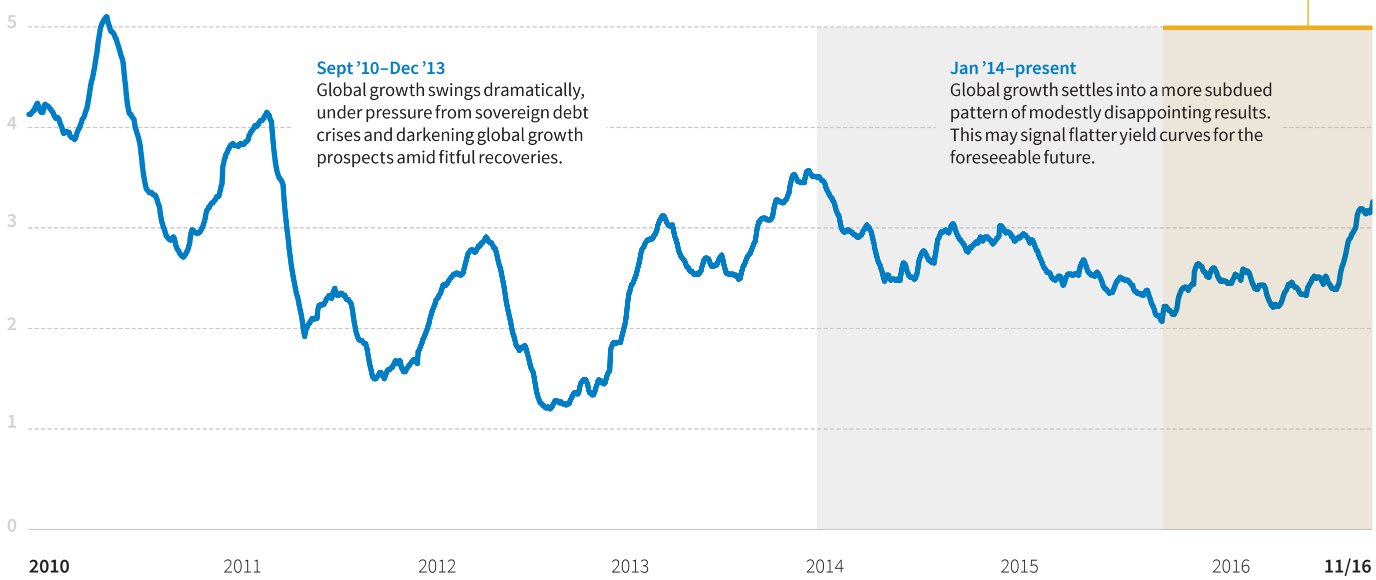
▲ 3.26%

U.S. consumer sentiment surveys improved in November, as did retail sales and new orders in durable and capital goods. U.S. employment and wage inflation were muted; housing was stable.



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 November 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.

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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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