THE MACRO REPORT | JANUARY 2017

# Real rhetorical deals

As of mid-January 2017, the markets are taking an optimistic view of what the new Republican control of Washington will bring. Looking back, December 2016 looks like a classic "risk-on" move, with global equities performing well and long Treasuries performing poorly. While the future of U.S. policy remains largely opaque and, for the moment, mostly rhetorical, we know what signals to watch for in the coming weeks.

This month we examine three dimensions of risk emanating from Washington D.C., and provide a roundup of key considerations for central banks in the United States, Europe, and Japan. Lastly, we continue our examination of China — focusing this month on how Chinese authorities are grappling with their currency problems. For 2017, the China puzzle remains, but the biggest uncertainty concerns the U.S. growth path under the deal-making aspirations of Trumponomics.

# Three dimensions of U.S. economic risk

**In our view, there are three areas of risk emanating from Washington: Fiscal policy, trade policy, and regulation and the business climate. In short, we know far less than we would like about the basic details of plans for implementing policy and regulation under the new political regime.**

## Questions of fiscal policy

With respect to spending, President Trump continues to support his infrastructure plans, and there is strong support among Congressional Republicans for relaxing the constraints on military spending. On the revenue side, there is broad support among Republicans for some form of personal tax cut. How large it will be and when it will become effective are still unclear, but we expect it to lift demand in the U.S. economy. It might be bigger and earlier in 2017; it might be smaller and later. It might be linked to limitations on deductions. Aside from these unknowns, the big questions concern how it fits into the administration's other fiscal plans and how the overall growth in the deficit will be handled.

For the time being, we think it would be prudent to assume two things: first, that we will see only a small boost to household demand; second, that there are clearly inflation risks associated with a large fiscal impulse.

On the corporate tax front, there are some big numbers being thrown around and some large changes being considered. This is not only a question of corporate tax rates; it is also a matter of tax incidence. Tax experts have long wanted to lower tax rates but broaden tax incidence by sharply reducing the number of special breaks that are in the corporate tax code, and the issue of "border adjustability" has also come into play.

There is no doubt that the U.S. corporate tax code could be changed in a way that enormously enhances efficiency and might even increase total federal tax receipts. The question is how uniform the tax code can become in the face of the army of well-paid lobbyists and campaign contributors anxious to preserve their special deals. The incoming administration, to the extent it has sent any signals at all about this, has indicated it likes the idea of an ad hoc approach to deals. This fact lends support to our skepticism about a genuine, growth-friendly tax reform package.

## What about the deficit?

If we take all of this at face value, the proposed tax cuts and infrastructure spending would lead to a large increase in the federal deficit, and would give a potentially big boost to nominal growth, with both real growth and inflation rising. However, although this growth impulse might last for a number of quarters, the Fed would have to respond to the changed inflation outlook. In addition, the mix of loose fiscal policy and tighter monetary policy would push the dollar higher, which would act as a brake on the economy.

But is such an outcome very likely? The Republican Party continues to be home to numerous fiscal hawks — one of whom has been appointed to lead the Office of Management and Budget. Indeed, Mick Mulvaney is a founder of the House Freedom Caucus and shut down the government to make a point about federal spending during President Obama's term.

Within the Congressional Republican Party, the orthodoxy is that tax cuts can be paid for by cuts to entitlement spending. But Trump's campaign promised no cuts to Social Security and Medicare, and polling evidence suggests Trump supporters are not free from anxiety about their incomes in retirement.

No one knows how this will play out. The Republican Party has many internal divisions — one of which has been on full display in the debate over Russia and cyber threats to the recent election. Perhaps Congress will resist the full range of fiscal measures that Trump advocates. We won't have to wait too long to get some insight, however, as the debt ceiling debate is fast approaching. Our guess is that, overall, we will have a fiscal impulse this year, but that it won't be very large.

### Words and action on trade policy

It could be that Trump's rhetoric on trade is just posturing to negotiate better deals, and probably will just be swept under the carpet. We are skeptical about this — primarily because of Trump's nominees to a range of executive posts.

Peter Navarro, an avowed protectionist, has been appointed to the new role of "Director of Trade and Industrial Policy" and as head of the newly created "National Trade Council." Robert Lighthizer, a lawyer with much experience seeking protection for the U.S. steel industry, has been tapped to head the U.S. Trade Representative office. And Trump himself has revealed his protectionist proclivities — witness his comments to major auto manufacturers regarding the balance of their North American production. Against this backdrop of tariff threats, we think it would be sensible to prepare for some early measures directed at China as well, and we note that the Office of the President of the United States has considerable authority to act on trade and tariffs without Congressional approval.

Again, however, we must point out that there are divisions within the Republican Party on trade — even within the group of close advisors who will be in the White House. Gary Cohn, for example, the Goldman Sachs executive whom Trump tapped to lead the National Economic Council, is an avowed advocate of free trade and is not likely to be quiet in internal debates on trade policy. But just as we think there is a risk of more fiscal stimulus than the fiscal hawks would like, we think there is a risk of more trade protection than the free traders will appreciate.

### Rising, not falling, regulation risks

One might think that if there is one thing all Republicans could agree on, it would be that reducing red tape, clarifying and simplifying business regulation, and setting out clear and fair rules for business are good. Curiously, however, this is not necessarily the case in practice, at least when it comes to health care.

It is quite remarkable that, some six years after the introduction of the Affordable Care Act (ACA), the Republican Party has been unable to reach an internal consensus on what should replace it. Congress has taken steps to "repeal" the ACA, but it appears likely that not all of it will be repealed, and there is no apparent consensus on which parts should be repealed. The supposed "replacement" of the ACA, moreover, has not been described in sufficient or consistent detail.

The economic impact of change could be significant. Health-care expenditure is about 18% of GDP, which, as a share of GDP, is about the same as the gross output of the entire manufacturing sector. Finance is also another huge sector of the economy and, again, there's a lot of talk about Dodd–Frank but no clarity about exactly what the new legislative regime will be.

Currently, one area we are focusing on is corporate investment, and we are formulating a carefully analyzed view on the possibility of an upturn in capital expenditure. We hope to have more to say on this in the next month or so. But, in the meantime, we would caution that regulatory uncertainty has risen so far this year, not fallen. Consequently, on balance we are inclined to think that the growth boost from the new administration will be modest, and will be more likely to add to inflation than to real growth prospects.

# Central banks at the crossroads

**The central banks of the United States, Europe, and Japan are at, or close to, policy inflection points. In the United States, we see core inflation close to target levels, but elsewhere, we think that sustained inflationary pressure is unlikely.**

## The U.S. Fed is in hiking mode

The Fed hiked in December 2016 and generated a flurry of excitement when there was some movement in the "dot plot" mapping Federal Open Market Committee members' expectations for future rates. A more careful assessment of the summary forecasts, the press conference, and the meeting minutes suggests to us that the Fed is, like us, waiting for more clarity on the fiscal policy outlook. Moreover, it is clear that the Fed is feeling more confident that the economy is continuing to use up excess supplies of labor.

If the economy continues on its current course — that is, notwithstanding any Trump-induced fiscal boost — then we would expect to see a couple of interest-rate hikes in 2017. If substantial fiscal measures are enacted, and if corporate animal spirits push up capital expenditures, then we think the Fed would feel the need to respond more aggressively. That said, the upward pressure on the dollar that we would expect from such a policy trajectory would probably perform much of the Fed's work for it.

If we see a surge in price pressures from protectionist measures, or a border tax, the Fed will likely react by hiking more aggressively, although, again, the Fed would end up being constrained by dollar strength. Nonetheless, it is important to note that the Fed is in a hiking cycle now — or at least it thinks it is — and the Fed is conveying that message to the market.

## The complicated world of the ECB

At its December meeting, the European Central Bank (ECB) announced that quantitative easing (QE) would be extended from March 2017 to at least the end of the calendar year, but at a reduced monthly pace. This provoked a long discussion among market observers about whether this was "tapering" or not. The big issue here is whether we should think about QE in stock or in flow terms. Is it the size of the central bank's balance sheet that matters or the flow of central bank purchases into the market? The ECB wants to argue that its balance sheet will continue to expand, and that it will be larger in December 2017 than it would have been otherwise. But many analysts said the drop in the monthly pace of purchases sent the more important message.

Academics and central bankers have pretty much reached the conclusion that it is the stock of QE that matters, not the monthly flow. Market participants are more likely to think it is the flow that matters, since that provides the daily demand in the market. We think the ECB thought it was sending a dovish message, saying it was continuing to keep easy monetary policy at a time when the Fed was sending a different message. The ECB, in other words, wanted to drive home the theme of policy divergence. But the reduction in the pace of QE sent the message to the markets that the end was in sight.

### The ECB has another problem — inflation

Headline inflation, driven by energy market developments and the drop in the euro, has moved significantly higher in the eurozone. Indeed, a few German banks have been muttering about the target being in sight. German CPI was 1.7% in December, which prompted the same people to declare that German inflation has reached its target.

Our inflation forecast sees core inflation in the eurozone edging up in the second half of 2017, but broadly stable throughout 2018 and well below the ECB's target. We also see headline inflation drifting down through 2018. However, our forecast also sees these developments occur only after inflation rises rapidly and higher than 2.0% twice in 2017. And therein lies the ECB's problem. It needs to keep policy easy to support the ongoing economic recovery and raise core inflation, but it faces political pressure that will come as headline inflation rises.

This is not to say that actual policy rates will rise any time soon. We expect rate divergence will continue. But the ability of the ECB to control monetary conditions, especially in the periphery, may be challenged. These risks are most serious in Italy.

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### Beyond Abenomics at the BoJ

The BoJ's yield curve control policy, which aims to keep the 10-year Japan government bond (JGB) yield close to zero, was certainly tested by the sharp rise in Treasury yields after Donald Trump's election. Then, in mid-December 2016, when the 10-year JGB flirted with a yield of 10 basis points, there was some serious talk in Tokyo about a possible BoJ response and about the dangers of such a response. In the event, the BoJ's resolve was not tested, and JGB yields drifted back down.

Importantly, the yield curve control policy gives freedom to fiscal policy and the government is beginning to take advantage of this. Japan is thus inching ever closer to using helicopter money. Moreover, the drop in the yen since Trump's election makes the BoJ's inflation target look more plausible. For the time being, therefore, the combination of a weaker yen, the yield curve control policy, and the fiscal expansion makes the BoJ the most dovish of the major central banks.

# China on the FX tightrope

The Chinese economy produced much better results in the second half of 2016 than many people expected. We continue to think that this is largely because of the stimulative steps taken by the Chinese authorities, but we continue to be troubled by China's economic outlook.

### Uncertainty is bad, but uncertainty plus tension is worse

We expect Trump to take a very different approach than Obama did to China, which we think will raise geopolitical and economic risks. But, even if U.S. trade policy with China does not change, it will not be clear for some time. As a result, we will probably have to get used to living with uncertainty over U.S./China relations.

In the meantime, China's economic challenges remain. Reducing the economy's dependence on credit, modernizing the production base, shifting the economy to focus on domestic consumption of goods and services, and preserving central control have proven to be difficult in a tolerably benign external environment. These challenges will not be any easier against a backdrop of an increasingly tense relationship with the United States.

### Questions of currency

It is also important to note that the Chinese private sector is increasingly nervous about the economic outlook. As a result, capital outflows have continued. In addition, the authorities are dangerously close to running into a classic problem with a pegged exchange rate. What do you do with a peg when the private sector begins to question its credibility? Defending the exchange rate by raising interest rates threatens harm to the domestic economy. But breaking the peg may cause damage, too, since it harms domestic balance sheets, especially of those actors who had treated the peg as though it were credible. When you peg to a currency that is appreciating for exogenous reasons, maintaining the peg creates other difficulties.

The Chinese authorities would like the yuan to depreciate at a slow and steady pace against the dollar, but Trump's election has pushed the dollar up quite significantly. The authorities thought they could diffuse some of the pressure by changing the basket against which they manage the yuan. They also have the longer-term goal of introducing some flexibility into the bilateral exchange rate with the dollar. The new basket has a lower weight for the dollar, but the announcement of the new basket had the effect of making investors nervous that further reduction in the dollar weight would be forthcoming, which would cause the dollar value of their assets to decline further. The problem is that basket weights matter for thinking about trade, but investors tend to care more about bilateral exchange rates.

Faced with this pressure, the authorities are reverting to the playbook they know best. They are reluctant to allow price adjustment — this would mean either freeing the currency to float or devaluing sharply and pushing up interest rates. So they are considering two quantity adjustments: to reduce the quantity of demand for dollars and to increase the quantity of supply.

Reducing the quantity of demand without the price mechanism means tightening restrictions. This is happening quite aggressively now, and Beijing is trying to offset the unpopularity of related measures by linking them to China's ongoing anti-corruption campaign. It is as if the leadership was saying: "We are only good patriots who are trying to stop corrupt officials from sending offshore their ill-gotten gains." Increasing the supply without adjusting price means making public sector supply available, which means selling reserves and leaning on state-owned entities to supply more dollars to the market.

We continue to think that the Chinese have the tools to control these issues, and that any worsening of Chinese troubles is unlikely to trigger a global financial crisis. But the underlying pressures are for continued outflows, and the economic risks are to the downside. As we have seen in the past couple of years, the Chinese growth outlook matters for global growth prospects, if only because the Chinese economy is now so large.

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**PUTNAM GLOBAL RISK APPETITE INDEX | JANUARY 2017**

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.

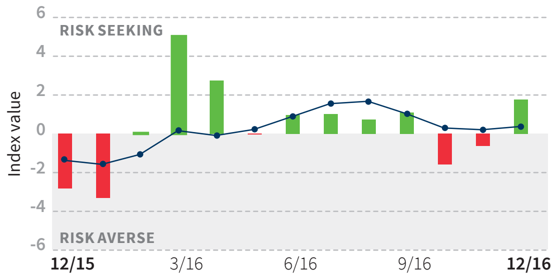
# Risk appetite turned positive in December

## SHORT-TERM TREND

In December, risk appetite was positive, in sync with a rally across global equity markets.

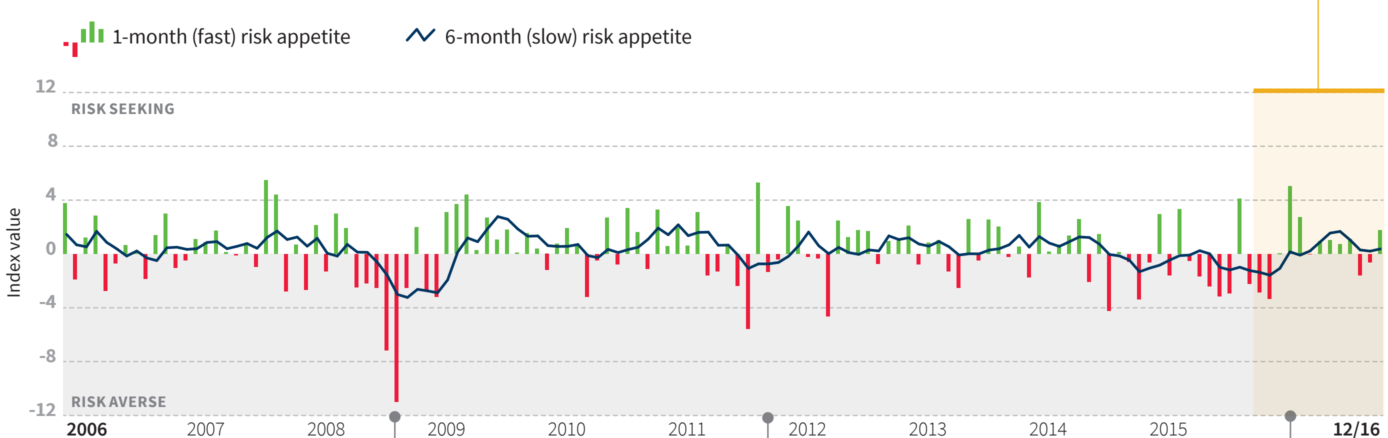
Risk ON OFF

- The U.S. stock rally that began in November extended to non-U.S. developed stocks in December. Non-U.S. stocks were also driven by currency depreciation relative to the U.S. dollar.
- Poor-performing fixed-income assets included longer-dated U.S. Treasuries and European bonds.




## LONG-TERM CYCLE

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




**Sept '08**
With Lehman Brothers' bankruptcy and the onset of the global financial crisis, appetite for risk all but disappears.

**Sept–Nov '11**
Eruption and subsequent clearing of concerns over EU sovereign debt crisis, U.S. debt ceiling, and fear of China hard landing drive major risk selloff and rally.

**March–Sept '16**
Risk assets rally amid improving commodity prices, perceived stability in China's macro data, and expectations for gradualist Fed policy.

Source: Putnam. Data as of December 31, 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.

**PUTNAM GLOBAL GDP NOWCAST | JANUARY 2017**

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.

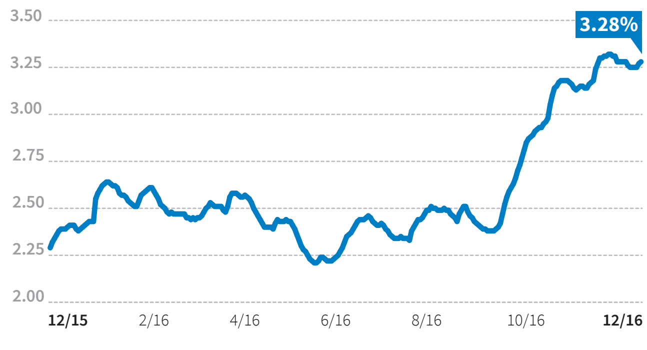
# Growth ended 2016 well above its recent range

## SHORT-TERM TREND

Global growth continued on a modest upward trend in December, mainly due to U.S. data.

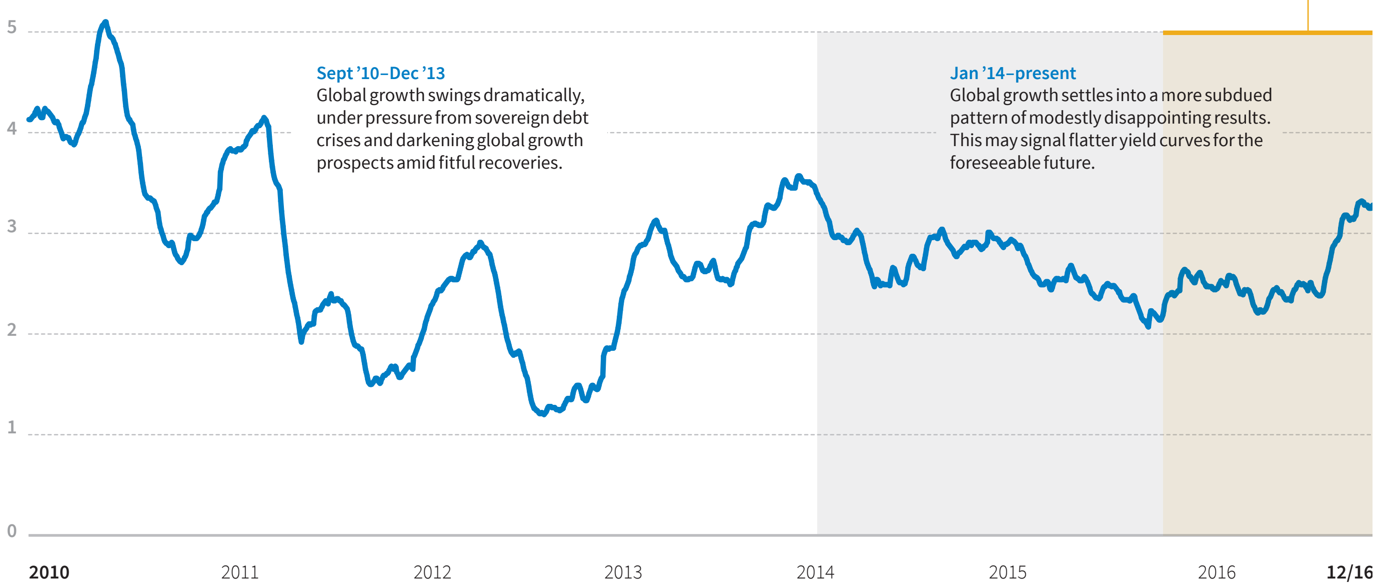
▲ 3.28%

U.S. consumer sentiment surveys improved in December. New orders in durable and capital goods showed significant improvements. 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 December 31, 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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