Increasingly, we believe we are witnessing late-cycle economic conditions emerge in the United States. The labor market is at or close to full employment, the positive contribution to growth from the ratio of new orders to inventories has ended, and banks are struggling to find customers for loans. This does not mean that a recession is imminent or likely, although it probably does mean that the odds of a recession are rising. There are policy risks to watch in the current environment, and there is also the risk that the private sector will react aggressively to the continuing squeeze in profit margins.

This month, we discuss some of the dynamics behind falling inflation, including corporations’ failure to restore margins by charging higher prices. On a separate note, we take a closer look at how EM assets have soared despite a downshift in local growth prospects and rising signs of economic and political disruption. China, we observe, continues to waste money on a colossal scale, and the country’s debt dynamics remain unattractive. Sooner or later, this could cause a major problem for investors.
Inflation eases

Although inflation appeared set to rise broadly just a few months ago, recent data confirm that consumers have just said no to higher prices.

We’ve had two bursts of inflation surprises over the past nine months. The first was in October 2016, when the strength of the commodity market began to affect headline inflation numbers. The second was early in 2017, when the “global reflation trade” and the “Trump trade” were both in full swing. Now, however, inflation has largely pulled back to its prior dynamics. Considering this through the lens of Federal Reserve caution and data dependency, we think the pace of future interest-rate tightening is now a bit more uncertain.

Consumers take a pass
As 2017 began, inflation climbed as companies made a determined effort to raise prices to restore their profit margins. Profits had been squeezed by rising labor costs — including wage and non-wage costs — and sluggish productivity growth. But this effort failed as consumers rebelled, and spending weakened. This dynamic was quite clear in the auto market, where sales downshifted, but that is not the only area of apparent weakness. Housing, for example, has begun to look problematic as well. Despite continued low interest rates, wage income simply is not growing fast enough to support more robust home purchases.

Inflation patterns have reverted
As a result of consumers’ behavior, companies have quickly reconsidered their pricing strategies, and the subsequent path of inflation has disappointed observers who were expecting inflation to drift higher. Inflation in the major economies looks very different than it did a few months ago, with U.S. and eurozone data dropping markedly. Moreover, as we show in the accompanying chart, the various components of U.S. inflation have all experienced a drop from their early 2017 patterns.

That said, we do not think we need to start worrying about deflation again. We expect core inflation to be broadly steady. Fears of a major shift in inflation dynamics, either much higher or much lower, seem to be misplaced.
Inflation has rolled over
Components of U.S. core inflation

 Longer-term risks continue to build
We continue to think that the environment remains favorable for risky assets, even though we acknowledge there are unknowns that could disrupt the current pattern. Of the risks we see, the biggest concerns how late-cycle dynamics will play out. How, for example, will the private sector react to the squeeze in profitability as the labor market tightens and inflation fails to rise? How much more will the Fed do after the June hike (which we continue to expect)? How will the markets react to the Fed’s first steps toward balance-sheet reduction?

We do not doubt that policymakers will be cautious and will quickly take into account any negative effects that policy adjustments will have on the markets. But, as we have discussed in recent months, the Fed’s approach to balance-sheet changes will inaugurate a significant new phase in policy, and its impact may be amplified if we suddenly find a cast of new and untested policymakers sitting on the Federal Open Market Committee.
Rising quits, stagnant wages

As the labor market improves, workers typically feel empowered to quit their jobs for better-paying opportunities. While quits are on the rise today, better pay is hard to find.

The May labor market report was somewhat weak, but not weak enough, we think, to change the mood at the Fed. After all, the labor market is still tightening, albeit at a slower pace. A key problem, though, concerns wages. Although we see continuing evidence of faster job creation in lower-wage sectors, this trend is not producing much in the way of aggregate wage increases.

The grass is always greener

Looking more closely at Job Openings and Labor Turnover Survey (JOLTS) data, we find a disparate story behind the national quit rate, a measure of non-retiring voluntary quits. The quit rate is important because it can be a leading indicator for wage gains: As more workers quit, businesses may realize they need to raise pay to retain their workforce. Now, that relationship appears to be in question.

As the quit rate has risen among leisure workers — food services and hotel management staff, for example — wages in this sector have also risen at a decent pace. In this, we see the normal relationship between quits and wages. But when we look at the quit rate in professional services, wages in the higher-paying sectors of the economy do not appear to be moving much.

The aging explanation

In large part, this difference in wage pressures may have to do with aging. Older, well-paid workers are being replaced, in many cases, by younger, less well-paid workers. The younger workers are happy to have jobs and to move from their parents’ basements, but, at the macro level, their willingness to accept lower salaries reduces observed wage growth.

One might think that wage pressures will begin to rise soon; the examples of former crises and recoveries certainly suggest a positive correlation between quits and wages. So far, though, we do not see that in the data. Of course, given the backdrop of the corporate profit squeeze, we think it is likely that the labor market will weaken in the coming months. Corporations will be doing what they can to rebuild their profit levels, and there is the risk that the private sector will react aggressively to the continued margin squeeze. If, as a result, the Fed decides it needs to tighten monetary policy more substantially, that could open up a scenario under which recession risks would rise quite sharply.
In leisure, wages have risen with quits
12-month average of demeaned quit rates versus average year-over-year % wage gains


In professional services, quits have climbed but wages have stalled
12-month average of demeaned quit rates versus average year-over-year % wage gains

The new consensus trade

Emerging markets have soared so far this year. While there is much to like about the asset class against the backdrop of weak global interest rates, there is much that argues for a healthy dose of caution.

The global backdrop has encouraged large capital flows into emerging markets (EM) so far this year, across equities, local bonds, and hard-currency bonds. When U.S. rates rise, on the expectation — or the hope — that the Fed will hike more aggressively, we see a wobble in this flow, but as rates ease, the flows resume. Of course, the trend in U.S. rates this year has been down, which has augmented the strength of investor interest in EM.

U.S. policy inaction has helped

In the past six months, fears about Trumponomics, protectionism, and border walls harmed capital flows to EM, especially to Mexico, but these fears have also tended to ease as the Trump administration has implemented virtually nothing on these fronts. This is not to say these issues have disappeared. The Trump administration could still empower the U.S. nationalist faction, withdraw from NAFTA, and impose trade restrictions, but this does not seem to be the way the wind is blowing.

Local turmoil? No problem

Interestingly, domestic political factors have been strikingly negative across EM so far this year. The South Korean president was removed from office. Turkey held a referendum on a constitutional change that many observers see as a sign marking Turkey’s illiberal future. In South Africa, President Jacob Zuma is under intense political pressure for deeply embedded corruption. And speaking of corruption, Brazilian President Michel Temer, who took office last year following the impeachment of Dilma Rousseff, has himself become embroiled in a corruption scandal. These developments matter for the economic outlook for these countries in many ways, but none of them appear to have done much to deter investors.

Domestic political factors have been strikingly negative across EM so far this year, but none of these developments have done much to deter investors.
China slows again
And then there is China. As our Nowcast for China shows, growth has slipped. Policymakers still seem to be in tightening mode, although they are also in heavy intervention mode. In May, China changed the way it manages the yuan’s exchange rate, introducing some discretion into the way the daily rate is calculated. The result is likely to be a partial re-anchoring of the yuan to the dollar, giving the authorities the ability to minimize tension with the United States.

China downgrade
The other interesting development in China was Moody’s credit downgrade. China had been rated Aa3 by Moody’s since late 2010, but in late May the rating was lowered to A1, which is where it had been from 2007 to 2010. In and of itself, this doesn’t mean too much, since it does not push China across the investment-grade barrier that matters for index inclusion and investor behavior. What was interesting, however, was the rationale Moody’s gave for the downgrade. Citing their “expectation that China’s financial strength will erode” and that “economy-wide leverage will increase,” Moody’s articulated something we have long felt: China’s debt dynamics do not look appealing.

Indeed, total debt is now 250% of GDP, which is the kind of level associated with countries that enjoy much higher income levels. Moreover, the policy mix in China means the actual and contingent liabilities of the sovereign are rising rapidly. While we believe China has the resources to deal with this and we do not think a crisis is imminent, the basic fact is that China is exhausting its financial resources at an alarming rate. At some point, we think this will cause a major problem — not just for China, but potentially for all of EM.
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 healthy in May**

**SHORT-TERM TRENDS**
Risk appetite maintained much of its recent momentum in May.

• Most financial assets rallied on the strength of global reflation.
• Non-U.S. assets continued to outperform U.S. assets.

**LONG-TERM CYCLE**
This 10-year illustration captures the cyclicality of investors’ appetite for risk.

Source: Putnam. Data as of May 31, 2017. 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.
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 held steady in May

**SHORT-TERM TREND**

Global growth generally remained positive in May, though growth in Asia declined.

Among G10 countries, the United Kingdom was the main contributor to growth. In Latin America, Mexico contributed strongly, while Asia declined — particularly on weakness in Singapore.

3.83%

**LONG-TERM CYCLE**

This six-year illustration captures GDP gyrations since the financial crisis.

Source: Putnam. Data as of May 31, 2017. 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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