As the summer winds down, the outlook for Fed policy, the North Korea crisis, and questions surrounding U.S. tax reform remain the chief areas of uncertainty for the global macro picture. Global growth indicators remained strong and markets returned to a risk-on appetite during July and August. August was also interesting in that risk assets such as stocks performed well, but gold and long-term Treasuries did even better. One interpretation is that a solid global economy is supporting risky asset prices, but nervousness over North Korea, and perhaps the U.S. debt ceiling expiration, prompted investors to bid for Treasuries.

An active hurricane season has caused some concern about impact on gross domestic product (GDP). Hurricane Harvey struck Texas’s oil-refining infrastructure in the Houston area, while Irma struck Florida. We estimated Harvey’s approximate GDP impact prior to the arrival of Irma, which is more difficult to estimate cleanly, but will certainly be negative. We continue to assess Irma’s effects, but as with other past hurricane events, the economic impact is temporary. The reduction in third-quarter GDP should be more than offset by a bigger recovery bounce that will be spread over the fourth quarter of 2017 and the first quarter of 2018.
Inflation in the foreground suits the Fed

We see little reason for confidence in the Fed’s view that negative U.S. inflation surprises this year are temporary and transitory.

Rent and lodging prices slacken

First, rents for primary residences are weakening at the tail end of a long-term story. In the aftermath of the housing crisis and the recession, demand for housing available for purchase was weak. Credit was difficult to obtain, people were scarred by the fall in house prices, and the recovery in employment in the early years was sluggish. As the economy picked up, so did demand for housing, but it was heavily biased toward demand for rented housing.

The U.S. housing construction industry, dominated by small firms accustomed to building houses in the suburbs, was ill-equipped to respond to the demand for multi-unit rental buildings closer to cities. It took a while for new supply to be planned and built. The rising demand combined with sluggish supply to produce rising rents, of course, and OER rose in tandem. We are now closer to equilibrium in these markets; demand for housing for purchase has recovered, and new rental supply has become available. So, pressure on rents has eased, and indeed in some places rents are now falling. While this trend means little for the housing market as a whole, it has implications for inflation, since it is rents — not house prices or the cost of owning a home — that drive housing in the CPI.

Lodging away from home has become a factor. This is not a large component of shelter, but it matters. Hotel occupancy is very high, so why are hotel rates not rising? The answer seems to be Airbnb and similar apps and services. Some people describe this as Airbnb

There are some genuine oddities in recent inflation trends (see chart). Medical care, one of the two biggest components of core CPI (Consumer Price Index) — the other is housing — stands out as an example. Medical-care inflation has been moving around in puzzling ways, rising until mid-2016 and falling since then. However, given the enormous regulatory uncertainty in health-care policy, it is difficult to be confident about the future trajectory of medical-care inflation. With regard to housing, the CPI for the broadest measure is shelter, and it has three components: rent of primary residence, owners’ equivalent rent (OER), and lodging away from home. OER and rent of primary residence move together, since OER is derived from rental statistics. The CPI for shelter had been a consistent source of inflationary pressure since the recovery from the crisis, but it is now easing for two main reasons.
doing to hotels what Amazon has been doing to retail outlets, but this is not entirely accurate. Amazon offers low prices, better inventory, and convenience, and this has changed the distribution channel for goods and services, but Amazon has not really led to an increase in supply. Airbnb and similar enterprises, on the other hand, have increased the supply of rentable rooms quite dramatically. It’s as if a vast number of new hotels had been built very quickly; existing hotels not only must compete with the hotel across town, they must also now compete with the spare bedrooms in every apartment in town. This is a very powerful effect, and frankly, it is hard to dismiss it as temporary and transient.

These trends will, we expect, cause inflation to move higher in the next few months, and this is pretty much baked in the cake. Indeed, the U.S. inflation forecast indicates a hurricane-related spike in headline inflation during October, followed by a sharp fall into early next year. Even as headline inflation begins to fall, core inflation will rise in the next few months, conveniently for a Fed that wants to hike in December. Looking toward next year, however, we expect core inflation to remain in a narrow range, at a level that is consistent with the Fed’s target, which therefore may not warrant further tightening.

What can be expected of the Fed?
It is fairly clear that the economy is doing well enough, and the Fed is confident enough about the economy, that balance sheet reduction will begin in October. In addition, we think it is the Fed’s current expectation that, if the economy keeps ticking along and balance sheet reduction does not generate stress in financial markets, there’ll be another rate hike in December. We think that short-term inflation dynamics will allow this. At this point, however, the outlook for 2018 does not look strong enough to warrant the Fed moving further.

A drop in several inflation components weakens the outlook for inflation
Components of core inflation, percent change, year over year

Source: Thomson Reuters Datastream.
Intelligence assessments continue to indicate that the Democratic People’s Republic of Korea (DPRK) has made significant advances in key areas. It has solid-fuel rockets as well as liquid-fueled ones, which matters because solid-fuel rockets can be launched more quickly and thus can be loaded onto harder-to-target mobile launchers. It also now has a long-range inter-continental ballistic missile (ICBM) capability. In addition, North Korea has made advances in nuclear miniaturization and can almost certainly put a nuclear warhead onto a missile, although whether the warhead could withstand the heat of re-entry remains unclear. Its ability to guide missiles also remains unclear. In all, North Korea has more nuclear capability and warheads than experts thought a few months ago and a recent test, which may have involved a hydrogen bomb, is another important advance. While rockets are subject to very high failure rates, that is not going to be very reassuring to those who might find themselves in the path of one.

Kim Jong-un confronts U.N. sanctions

North Korea made moves during the summer in response to the regular annual joint military exercises involving the United States and South Korea, and to the United Nations decision to tighten sanctions on the regime. The North launched a missile that flew over Japan and came down in the Pacific Ocean just south of the Kurile Islands, ownership of which is disputed between Japan and Russia. Its subsequent underground nuclear test was very large. This was widely seen as an indication that Kim does not intend to be deterred by the U.N. sanctions, and it was a clear escalation in the type of response from the DPRK that we have seen in past years around the time of the joint U.S./South Korea military exercises. In addition, North Korea continues to threaten Guam, although in terms that are somewhat milder than during August.

President Trump recently insisted that “all options are on the table,” and he has the difficult task of making the threat of preemptive military action credible, when most people think it is not.
In an interview conducted and published shortly before he left the White House, the President’s former strategist Steve Bannon commented that there are no viable military options to disarm North Korea preemptively given the damage that it could inflict very quickly on Seoul. And therein lies the problem. President Trump recently insisted that “all options are on the table,” and he has the difficult task of making the threat of preemptive military action credible, when most people think it is not. At the same time, it remains true that, if a war were to start, the North would lose heavily and quickly, but not before massive losses in Seoul and elsewhere.

Despite its actions, it still seems clear that North Korea does not want to start a war. However, there is the possibility that one side or another will make a serious miscalculation. George Bush’s team and Saddam Hussein did, and we are still living with the consequences.

We have leaders of two countries threatening each other, and one of those countries is launching missiles and conducting nuclear tests as well.

Are North Korean nukes here to stay?
The Japanese and others think there is a path of mutual de-escalation, but it means that the United States must learn to live with the DPRK as a nuclear power. We’ll just have to see if this is the path that ends up being taken.

In the meantime, we have leaders of two countries threatening each other, and one of those countries is launching missiles and conducting nuclear tests as well. The risk of something going horribly wrong may not be very high, but it is higher than one would like.

Trade tensions with China remain possible
It’s also worth noting that it is not only the raw geopolitics of this crisis that are concerning. China and the United States approach the problem differently, and their interests do not align. As the United States moves to tighten sanctions against North Korea, it is possible that more Chinese companies will be affected. Trump has made some claims that have been interpreted in Beijing as indicating a willingness to use trade as a way to pressure China to cut off oil supplies to North Korea. And there remain important voices in the White House that would love any excuse to increase the likelihood of trade measures against China. Needless to say, a trade war with China would have important economic repercussions.
We can watch the tax debate unfold over the autumn, but there are a few things that are already clear. The first is that the White House is backing out of the process, or at least out of the details of the debate. For a while it seemed as though the White House might be trying to develop some genuine expertise on tax matters in order to have a credible voice in the debate and influence the outcome, but most recently it has shifted responsibility to Congress. The president has promised to give major speeches in favor of reform, but that is pretty much what happened with health care.

Within Congress, there remain deep divisions over the way forward. Is the total tax burden on corporations or households, or both, to fall, or is the tax burden to be redistributed in such a way as to enhance short-term or longer-term growth prospects, while keeping total revenue broadly unchanged? If the former, is the deficit to be allowed to grow, or will spending be cut to keep the deficit manageable? If the latter, whose taxes are going to go up to allow taxes on favored sectors to go down?

The border adjustment tax debate revealed the obstacles
These are serious conflicts, and they must be faced pretty much full on. You can buy a bit of room through imaginative accounting, but not enough to make a material difference. We have already learned a fair amount about how the wind is blowing. Under the original House Republican plan, the increased revenue from the border adjustment tax, the BAT, was used to finance lower rates for other sectors. Lots of analysts got quite excited about this, as it seemed a genuine advance in the approach to taxation. It was serious, it was radical, it had a lot of expert support, and it raised enough money to finance other tax cuts. It might even have been growth enhancing. But it ran into a political buzz saw. The two Senators for Arkansas, the home state of Walmart, were key in seeing it off.
It’s hard to come away from that experience and think that any other key sectors and their well-paid lobbyists are going to offer themselves up on the sacrificial altar of longer-term growth. Will the oil and gas industry give up its extraordinary tax privileges? Hmm. Let’s think about that one.

The other ideas that are being thrown around on the household tax side also face problems. The big tax deduction for mortgage interest has very few serious defenders, but it has an army of lobbyists ready to protect it. One other idea that gets a lot of expert support is to abolish the federal deduction for state and local taxes. Red State Republicans, in particular, love this one because high-tax states are almost all Democrat-leaning states, so they could enhance tax efficiency and punish their political opponents. The electoral problem, and therefore the political problem, is House Republicans from high-tax states: There are 14 House Republicans from California, 8 from Illinois, 9 from New York, and 6 from New Jersey. That is a total of 43 votes from high-tax states when the Republican majority in the House is 32.

### Counting federal dollars and Congressional votes

In short, potential sources of opposition to reform appear to be numerous, and there is little evidence of the kind of leadership that could steer a course through these conflicts. The path of least resistance is one that lowers rates a little on the corporate side, with a bit of tinkering here and there and full use of “dynamic scoring” to gain a bit of wiggle room. Of course, this would have only trivial effects on growth in the long run. But let’s not give up on it yet. We can watch the debate unfold in the coming months, and look for signs that the Republicans can come up with compromises that eluded them in health-care reform.

The path of least resistance is one that lowers rates a little on the corporate side, with a bit of tinkering here and there and full use of “dynamic scoring” to gain a bit of wiggle room.
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 returns to positive levels

**SHORT-TERM TREND**
After the June dip, the risk appetite was positive in July and August.

**Risk ON OFF**
- Risk assets performed well, but were eclipsed in August by U.S. Treasuries and gold
- Within equities, EM had the best results, with U.S. small caps underperforming
- Fixed-income assets also generally did well, but spreads widened a bit

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

Source: Putnam. Data as of August 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 pace improved during summer

**SHORT-TERM TREND**

Global growth rose in July and steadied in August.

With the G10 showing vigor, only Canada slackened. Among emerging markets, South Africa and Malaysia slowed, while Mexico contributed to Latin American growth.

**LONG-TERM CYCLE**

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

Source: Putnam. Data as of August 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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