We are seeing a return of the threat of protectionism in the United States. President Trump recently placed tariffs on imported solar panels and washing machines, sparking concern the country may prompt trade wars. This comes as the administration renegotiates the North American Free Trade Agreement (NAFTA) with Mexico and Canada. China has also been a target of recent trade rhetoric. If the administration withdraws from NAFTA or imposes a spate of anti-Chinese trade measures, there will be downside risks to the U.S. economy.

As trade issues linger, investors also have to contend with a weaker dollar. Treasury Secretary Steven Mnuchin broke with tradition in January when he declared that a weaker dollar is good for American trade. Interestingly, although Mnuchin’s comments paved the way for more losses in the greenback, they weren’t the key to the currency’s weakness. Its decline to three-year lows in January was driven by the U.S. current account deficit and risk appetite. Stronger global conditions also play a role. For example, Germany’s economy continues to be a bright spot in the eurozone — enough to encourage local unions to push for higher wages.
We have seen a return of the threat of trade protectionism in the United States. President Trump recently placed tariffs on imported solar panels and washing machines, sparking concern that the United States may prompt trade wars. This comes as the administration renegotiates the North American Free Trade Agreement (NAFTA) with Mexico and Canada, and Trump has repeatedly threatened to withdraw from the pact. He has also targeted China in his efforts to seek more favorable trade terms. If Trump does withdraw from NAFTA, we envision considerable economic disruption, and the same is true of the trade relationship with China.

The story of the washing machine
Domestic manufacturers never like losing out to imports. Their first response is always to turn to their governments. And in reaction to complaints from local U.S. manufacturers (the sector accounts for roughly 12% of GDP; the ISM Manufacturing Index is a key indicator for the overall economy), the administration imposed restrictions on imported solar panels and washing machines. While the washing machine story is more important, tariffs on solar panels garnered much press attention given the interests of the fossil fuel industry and the pace that households are adopting solar technology.

There are perhaps 1.5 million solar installations in the United States and about 10 million washing machines sold every year. Domestic manufacturers already enjoy substantial protection since washing machines aren’t at the cutting edge of technological development, and they have a poor volume to value ratio. Shipping a washing machine means shipping a lot of air in a product that is not particularly valuable. The tariffs will increase the prices of washing machines in the United States, and a lot of households will be affected.

The tariffs raise the question of whether this is a signal of further developments on the trade front or just a
The ISM Manufacturing Index

Source: Thomson Reuters Datastream (February 2018). The ISM Manufacturing Index is based on surveys of the manufacturing industries by the Institute of Supply Management.

U.S. manufacturing has been expanding

continuation of the pipeline of trade issues. Trade law cases involving steel and aluminum are working their way through the system and are close to the finish line. Shortly after his inauguration, President Trump withdrew the United States from the Trans-Pacific Partnership (TPP), a 12-nation trade deal that included among others Japan, Mexico, Canada, Australia, and New Zealand. The 11 nations, excluding the United States, are expected to sign a pact in March in Chile. And, talks on changing the South Korea–U.S. Free Trade Agreement (Korus) are also underway.

There is a clear divide between Trump and the Republican orthodoxy on trade issues. The Republicans in Congress have been doing all they can to restrain Trump’s protectionist instincts. Capitol Hill is highly supportive of both NAFTA and Korus. But unlike health care and taxes, where the decisive factor was the (in)ability of the Republican Party to find some internal unity, the executive branch has more legal autonomy on trade issues.
**NAFTA: Good cop versus bad cop**

As the NAFTA negotiations get underway, Trump is playing good cop to U.S. Trade Representative Robert Lighthizer’s bad cop. It’s hard to feel confident about a likely outcome at this stage because all parties have little incentive to compromise. The Canadians are playing hardball. Lighthizer is known as a tough negotiator, but he’s not going to withdraw from NAFTA on his own; that’s a decision for Trump.

There’s nothing but downside risk to the U.S. economy. Our guess is that NAFTA will survive, and perhaps there will be one or two tweaks that make it a slightly better deal. But there’s nothing there to produce a better outlook for the U.S. economy.

Lighthizer is known as a tough negotiator, but he’s not going to withdraw from NAFTA on his own.

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**Complex relations with China**

There are clear links between trade and geopolitics, especially with China. And there is economic risk from disruptions in trade relations with China. It’s hard for the “trade is unfair” folks to get anywhere without talking about China because it is the biggest “source” of the U.S. trade deficit. Trump has acknowledged the complexity of the relationship with China given the range of issues that Washington and Beijing need to discuss.

A finely tuned administration may be able to come up with targeted trade measures. These measures would create powerful incentives for the Chinese to adjust some of the practices that U.S. companies find difficult to deal with, without disrupting global supply chains. Can the Trump administration do it? Our guess is that the trade rhetoric will continue, and isolated cases like washing machines will provide a few headlines. However, the administration lacks the determination to change the fundamental direction of global trade policies.
Spotlight on the dollar

Treasury Secretary Mnuchin breaks with tradition by declaring that a weaker dollar is good for U.S. trade, prompting a further slide in the currency.

U.S. Treasury Secretary Steven Mnuchin broke with tradition in January by declaring that a weaker dollar is good for American trade. The greenback extended its 2018 drop against most other currencies after Mnuchin’s comments at the Davos meetings. Mnuchin is the first Treasury Secretary to diverge from the mantra espoused by Robert Rubin, Treasury Secretary under President Clinton, that “a strong dollar is in the nation’s interest.”

The dollar floats as freely as any currency. The Treasury’s pot of money for currency intervention is tiny, and large advanced economies rarely intervene in their currency markets. While we don’t believe the comments signal a new “dollar policy,” some in the markets viewed it as a weaker dollar strategy. Not coincidently, a weak dollar would be consistent with some of the economic goals of the Trump administration. It would improve U.S. manufacturers’ competitiveness, reduce the trade deficit, and boost the government’s efforts to aid the manufacturing sector.

Current account and risk appetite fuel dollar losses
While Mnuchin’s comments paved the way for more losses in the greenback, they weren’t the key to the dollar’s weakness. Its decline to three-year lows in January was also driven by the U.S. current account deficit and risk appetite. The dollar fell between 4% and 7% from its peak in November 2017, with about half of the depreciation in January. Exchange rates are prices, and like other prices, they are determined by the balance in supply and demand. The dollar declines when the supply rises relative to demand, and the currency depreciates to entice new buyers and discourage new supply.

A widening deficit
The biggest single source of the global supply of dollars is the current account deficit. The United States pays dollars to the rest of the world for the goods and services it imports. These typically exceed the dollars the United States earns by exporting goods and services. So, what changed recently? The current account deficit is set to start growing again as the economy expands, and the benefits of higher energy exports start to wane. The trade deficit in November was the largest since the 2008 financial crisis. As a result, the supply of dollars is rising and is set to increase from this source.
The state of risk appetite

A second factor for the decline in the dollar is the state of risk appetite. Stronger risk appetite is associated with U.S. investors buying risky foreign assets. As U.S. residents buy assets, along with goods and services from the rest of the world, the supply of dollars increases. Strong growth in the eurozone has played a role in the dollar’s value. Growth among eurozone countries and a decline in the political risk premiums attached to their assets have raised the attractiveness of European assets to U.S. investors. Higher supply of dollars will cause the value to fall unless foreign demand for U.S. assets rise. But, there is no real sign of increased demand for U.S. assets.

This is partly due to valuations given the rally in U.S. equities. And there is no sign of any change in net foreign direct investment (FDI) flows. The United States typically has large FDI inflows and outflows, and the net position can be quite volatile from quarter to quarter. This is also a key reason why interest rates are rising. International investors tend to buy U.S. assets when there are prospects for higher returns, and they may not be seeing higher returns ahead.
Germany, the eurozone’s largest economy, raised its official 2018 GDP growth forecast to 2.4% from 1.9% previously. The upward revision matters more in Germany than many other countries because of the role the official forecast plays in the budgetary process. The economy may be benefiting from the inflow of migrants over the past few years, partly because many of these new arrivals are highly skilled engineers, doctors, and other professionals.

Germany is beginning to show some signs of overheating. Local unions are pushing for higher wages, but inflation risks remain very small. IG Metall, the country’s most powerful labor union, called for a 24-hour strike after a fifth round of failed talks with employers. This is unusual because deals were previously reached after three or four rounds of negotiations. We can’t recall the last time IG Metall called a strike. So, are we seeing the Philips curve in action in a unionized economy? Is labor militancy a sign that wages are about to move higher in Europe even though unemployment remains quite high? The answer is no.

IG Metall asked for an 8% pay increase over 27 months, while employers offered a 6.8% raise, according to German press reports. In annual terms, this means the union was asking for a 3.6% raise and employers were offering a 3% pay increase. Even if union workers get their full request, it hardly seems likely to break the bank.

Local unions are pushing for higher wages, but inflation risks remain very small.

Recent wage negotiations could push inflation closer to the European Central Bank’s target in a few years.
Germany’s business confidence is on a steady rising trend

![Graph showing business confidence trends for Eurozone, Germany, France, Italy, and Spain from 2008 to 2018.]

Sources: European Commission, France – INSEE, Germany – IFO, Italy – ISTAT, Spain – Ministry of Economy (February 2018).

**Union wages linked with economy**

There’s a link between IG Metall wages and wages in the economy. If workers get a 3.5% pay increase, wages in the economy are likely to increase by about 2.5%. With productivity growth at around 0.7%, it would suggest wage costs are rising by about 1.8%. When you include some non-wage benefits, wage costs may increase to 2.0%. Therefore Germany, one of the best performing economies in the region, could see inflation at the ECB’s target in a couple of years. Still, a wage-price spiral does not seem about to burst into view.
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 provides a framework for discussing investor preferences and can signal trend changes in broad market sentiment.

Risk appetite on a positive trend

**SHORT-TERM TREND**
January was another positive month for risky assets

- Strong risk appetite for equities; the six-month equity risk appetite measure was one of the strongest recorded
- As interest rates rose, long duration fixed-income assets had negative returns
- The weakness in the U.S. dollar means non-U.S. assets performed particularly well

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

Source: Putnam. Data as of January 31, 2018. 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.

The growth trajectory remains robust

SHORT-TERM TREND
Global growth improved in January

4.23%

Among G10 countries, growth picked up in Canada and the United Kingdom. New Zealand’s manufacturing activity slipped, and monetary conditions weakened. Growth improved most notably in the Central and Eastern Europe, Middle East, and Africa (CEEMEA) regions, led by Turkey. Asia’s growth forecast was stable.

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

Source: Putnam. Data as of January 31, 2018. 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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