THE MACRO REPORT | MARCH 2018

Cross currents in global markets

February saw a sharp reversal in risk appetite as investors shifted out of global equity and bond markets. Evidence of economic strength, including a tight labor market and rising wages in the United States, drove Treasury yields higher. The wage growth in January fed market fears about inflation and raised concerns that the Federal Reserve will quicken the pace of interest-rate hikes in 2018. Since then, calm has somewhat returned to Wall Street.

Markets are also absorbing the recent flurry of global economic and policy news. The budget deal ushered in by the U.S. Congress is expected to benefit economic growth. However, recent steps toward protectionist trade policies create downside risks to this outlook. President Trump slapped tariffs on aluminum and steel imports, weeks after announcing tariffs on washing machines and solar panels. In China, President Xi Jinping's supporters succeeded in lifting a constitutional provision on the length of time he can serve.

THIS MONTH

Risk appetite wanes

New era in U.S. fiscal stimulus

China's new emperor

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Risk appetite wanes

Global markets tumbled as concerns about inflation and higher interest rates drove investors to pull out of equities and bonds.

February brought a sharp reversal in the Putnam Global Risk Appetite Index. It was one of the 10 worst reversals in our Risk Appetite Index in the past 15 years. By contrast, last month we were discussing the strength of the various measures of risk-taking and concerns that some valuations were a little stretched, especially since risky assets rarely do well when interest rates rise.

In early January, the rally in bond yields was more Europe-centric, fueled by meeting minutes from the European Central Bank (ECB) and hawkish comments by several ECB members. However, toward the end of the month that theme waned. The rally in the yields of fixed-income securities continued in February, but with a different flavor. February's bond rout was more U.S.-focused.

Evidence of economic strength, including a tightening labor market and an improving outlook for wage gains, drove bonds yields higher. The market retreat worsened in February on concerns the Federal Reserve will accelerate its rate-hike schedule.

Upside interest-rate risk?

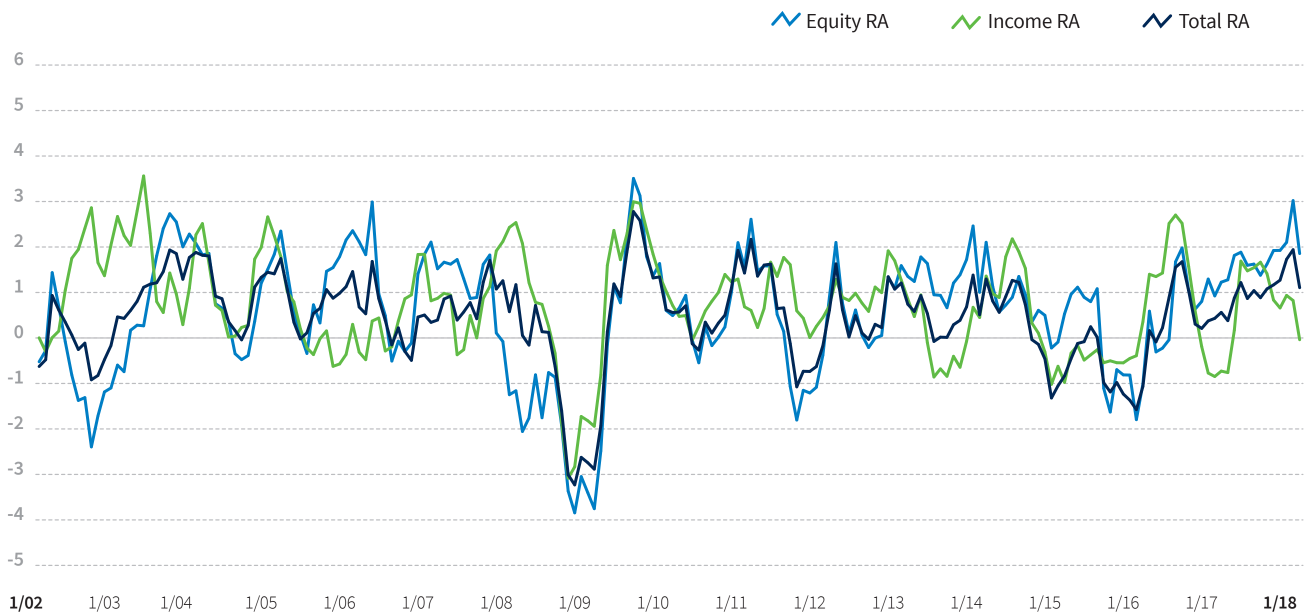
The labor market began 2018 on a strong note as Americans saw wage gains accelerate and hiring improve. Nonfarm payrolls grew by 200,000 in January, and the average hourly earnings gained 2.9 percent from a year earlier, the most since June 2009, according to Labor Department data in February. The jobless rate held at 4.1 percent. The wage growth sparked concerns about rising inflation.

The data also reinforced the Federal Reserve's outlook for three interest-rate hikes this year under Federal Reserve Chair Jerome Powell. Powell's Congressional testimony, on the other hand, raised concerns that a fourth rate increase may be possible. In the aftermath of Powell's upbeat remarks, stocks plunged by the most since 2016 and the yield on 10-year Treasuries rose. The market sell-off continued in Europe and Asia.

It was one of the 10 worst reversals in risk appetite in the past 15 years.

Risk appetite deteriorates

(Global Risk Appetite Index – 6-month)



Source: Putnam. Data as of February 2018.

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.

Yield curve flattens

As we are already in a hiking cycle and the theme du jour was inflation, the sell-off in rates was led by the front end of the yield curve, and so the curve flattened. Against that backdrop, it is not surprising that European government bonds were one of only two of the asset classes we follow that produced positive returns in February. The other one is non-energy commodities due to the solid performance of agricultural commodities. All other asset classes had negative returns. The outperformers of last month — international equities — were the underperformers this time, partly because the U.S. dollar stabilized in February after a sharp sell-off.

As we write this, we essentially have a neutral stance on interest-rate risk globally, but we favor a cautious posture at the front end of the U.S. yield curve, in particular. We believe there is risk that interest rates will move higher. Still, powerful global factors will limit the rise in the 10-year Treasury yield, in our view.

It would be very unusual to have a second consecutive month of such poor risk appetite, but equally it would be unusual to see it bounce back strongly. There are, as always, some cross currents that markets are trying to price; U.S. growth dynamics look to have slipped just a little, but they remain good and the latest commentary from Fed officials has been optimistic. On the other hand, the risks of an economy-disrupting trade war have clearly risen.

New era in U.S. fiscal stimulus

The budget deal clears the way for Congress to increase spending on a variety of programs, including infrastructure.

The U.S. economy is poised to pick up some speed this year given indicators for capital expenditure and the large budget agreement. The economy is likely to benefit from the fiscal spending package ushered in by President Trump and Congress a few weeks ago. Similarly, we expect to see a positive impact from the budget deal on economic growth. While we can debate how much of the impact will be nominal and how much will be real, the economy is likely to grow a little more quickly in 2018 because of the stimulus.

With a strong labor market, it would seem that stronger GDP growth would certainly bring the Fed into play. The Fed raised interest rates three times in 2017, referencing an improving economy and labor market. If the economy continues on this trajectory, then four interest-rate hikes this year will become the base case scenario.

Data indicators mixed

Recent U.S. data has been mixed. While manufacturing and confidence remain high, other data has been weak. Housing and auto numbers are normalizing after the post-hurricane boost in the fourth quarter of 2017. In addition, consumer spending growth cooled, gaining only 0.2 percent in January. Many growth trackers suggest that first-quarter GDP growth could come out well below a seasonally adjusted 2.0% quarter on quarter.

Despite the mixed outlook, the underlying story of the economy remains good. The labor market is the best indicator of this. The February data showed very strong job gains. What is interesting is that the wage data came in weak; January's jump in average hourly earnings was not repeated last month. However, there are a couple of things that are worth noting: Wage growth in manufacturing is now quite rapid, while quit wages and wage growth in leisure are falling. Although leisure is a large sector, it's a low-wage segment, and it is interesting that labor market tightness is not producing wage gains at this point of the wage/skill distribution.

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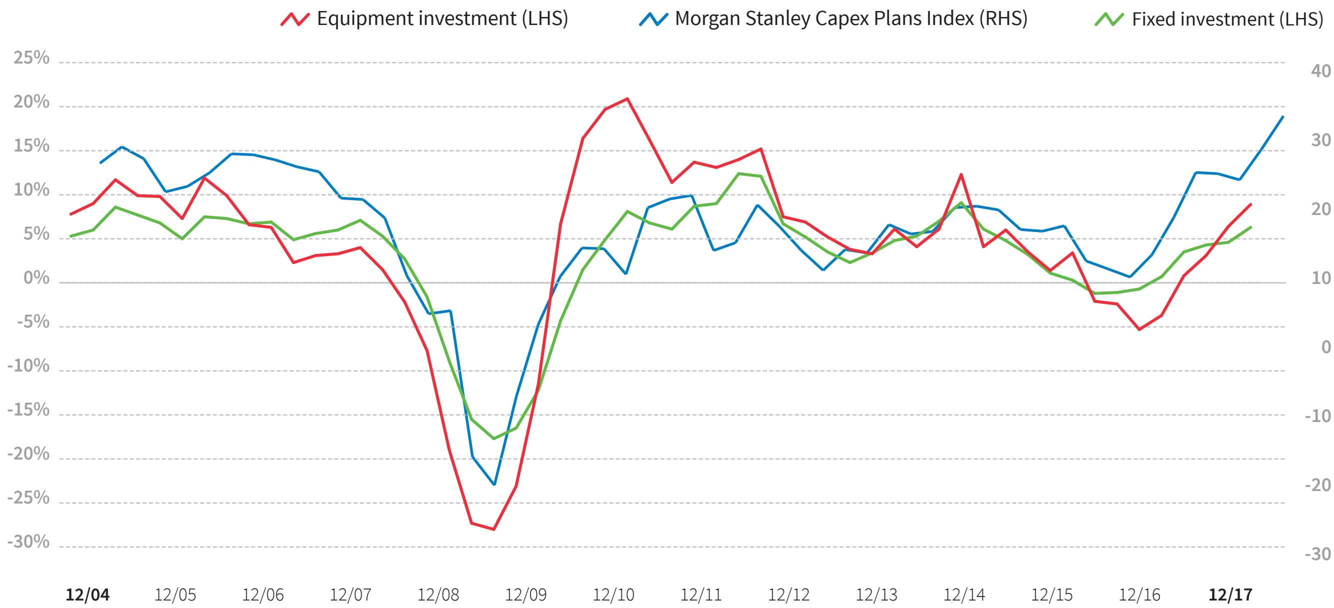
U.S. capital expenditure (Capex) on the rise

Capex (year-on-year)



Sources: Putnam, Bloomberg , Morgan Stanley. Data as of February 2018. The Morgan Stanley Capex Plans Index is a 3-month moving average of a population-weighted composite compiled from various monthly Federal Reserve Bank surveys of manufacturers measuring 6-month capex plans.

Trade policies negative for the economy

We wrote at some length last month about the threat of protectionism, and it's fair to say that the risks of a policy mistake have risen quite sharply over the past few weeks. With the resignation of Gary Cohn, President Trump's chief economic advisor, the nationalist/protectionist wing in the White House has gained ascendancy. While the Republicans on Capitol Hill retain their attachment to free trade, the presidency has autonomy in matters of trade. It's also worth recalling that opposition to free trade is one of the few ideological positions that President Trump held with anything approaching consistency over the years. Despite his firmly held beliefs, tariffs will not close the U.S. trade deficit, absent higher savings (in the public or private sectors) or lower investment.

The President's recently imposed tariffs are not, in and of themselves, likely to have material macroeconomic effects even if they will shift profits around the economy and create some unwelcome distortions. However, there are real reasons to worry. Firstly, a tariff is least disruptive if it applies across the board, but these tariffs are being implemented as a negotiating tactic, which just creates incentives for firms to engage in genuinely unproductive behavior. The second concern is what it suggests may be coming, and it's hard not to be discouraged on this front. Large scale interventions in trade now seem reasonably likely, and these will certainly draw retaliation from other countries. The European Union has developed some expertise in retaliation, choosing U.S. exports that are made in places dominated by the political supporters of the protectionists. We believe the Chinese will likely follow the European example, and it would be very easy for them to pick on U.S. agricultural exports.

In the space of the last month, we've gone from an environment where policy was supportive of the growth outlook to one where policy is creating serious downside risks.

We'll have to wait and see how serious this is, and ask how much retaliation will there be and how far will the Trump Administration push things? We can't quite yet quantify this into a GDP forecast for 2018 and 2019. However, in the space of the past month, we've gone from an environment where policy was supportive of the growth outlook to one where policy is creating serious downside risks. These might not materialize, of course, but we find it hard to be optimistic.

China's new emperor

Changes in the president's term limit could lead to capital misallocation and risks in the financial system.

President Xi Jinping's supporters have succeeded in their attempt to lift the constitutional provision on the length of time a president can serve. The change was ratified by the National People's Congress this month. The two-term limit was in place for about 20 years. For that reason, you may be tempted to argue that it's no big deal, but it was part of the move China made to change direction after the end of Maoism.

The question is whether it really makes sense to run the world's second-largest economy, with a population of 1.4 billion, from a handful of offices in Beijing staffed by Maoists.

Xi is a Maoist. In addition to removing term limits, his backers are pushing for a package of measures that will unify a large number of government structures under Communist Party control. Deng Xiaoping, who was a great reformer, had placed a lot of emphasis on separating the Party from the everyday machinery of the government. Xi and his supporters claim they want to "strengthen the Communist Party's leadership in every sector." The question is whether it really makes sense to run the world's second-largest economy, with a population of 1.4 billion, from a handful of offices in Beijing staffed by Maoists.

China's growth holding steady

The Putnam China GDP Nowcast Index (quarter-on-quarter)

Source: Putnam. Data as of March 9, 2018.

We base our individual country GDP Nowcasts on a tailored methodology that captures daily data releases for the most essential growth characteristics for the specified country — 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.

Economic risks

These political issues create risks for the economy over the long term because this system of government leads capital to be misallocated, creating bad assets on the books of the financial system. This is what's in China's future, although not this year.

In addition, Chinese macroeconomic data seem to have deteriorated a little. However, it's hard to interpret the data flow in January and February because of the changes in the timing of the Lunar New Year. The government has set a GDP growth target of around 6.5%, the same as in 2017. China also trimmed its fiscal deficit target for this year. The economy expanded 6.9% last year.

It's not clear that both of these targets are achievable, but there's no money to be made shorting Chinese government targets. Keeping the growth target the same as last year is a clear signal that the government is not interested in risking slower growth by advancing reforms more rapidly.

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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.

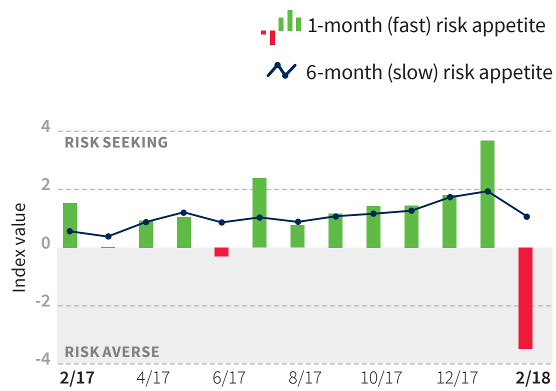
Risk appetite deteriorates

SHORT-TERM TREND

February saw a reversal in appetite for risky assets

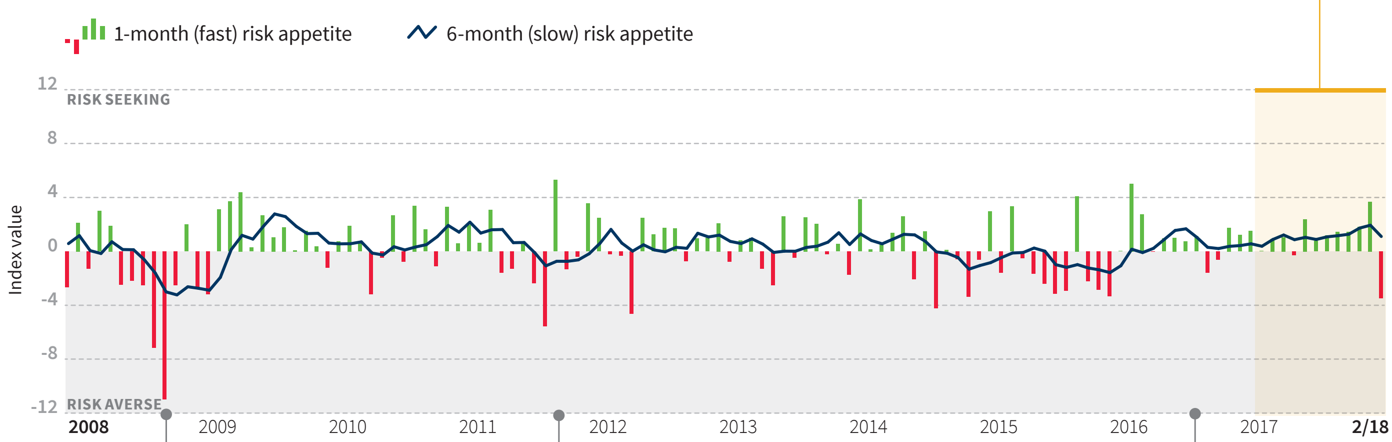
Risk ON OFF

- International equities were underperformers as the dollar stabilized in February
- The yield curve flattened as the sell-off in rates was led by the front end of the curve
- European government bonds and non-energy commodities had positive returns



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 February 28, 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 stable

SHORT-TERM TREND

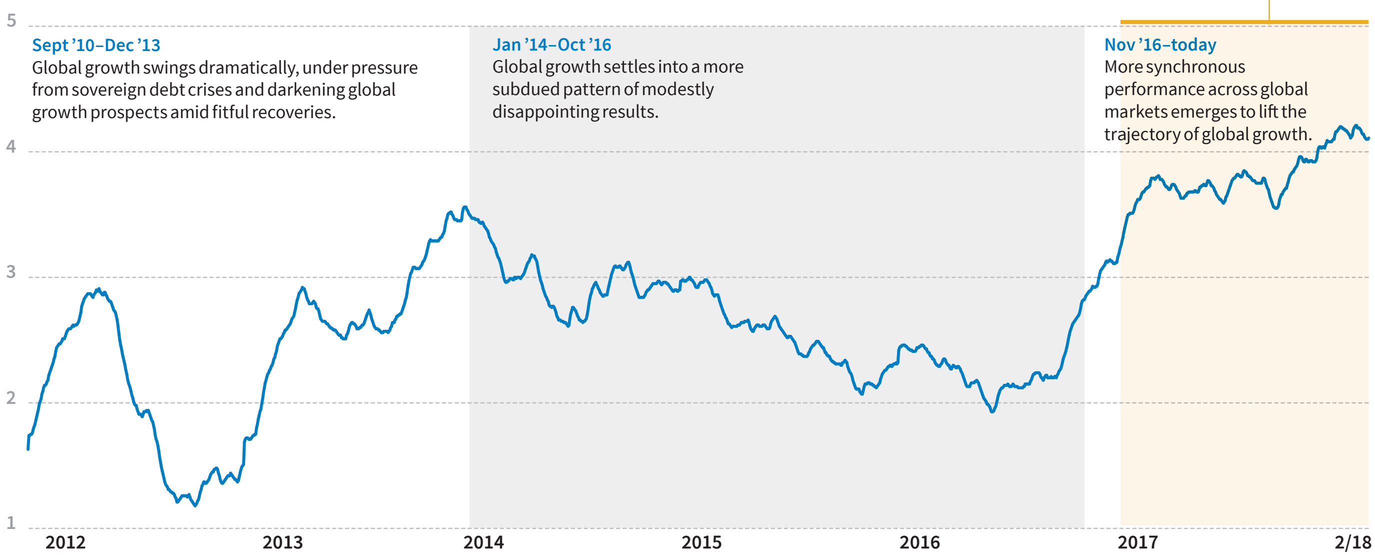
Global growth was little changed in February

▲ 4.11%

Among G10 countries, growth picked up in the United Kingdom and New Zealand. Growth slowed in Canada and Sweden. Turkey and South Africa's economies expanded, leading growth among countries in the Central and Eastern Europe, Middle East, and Africa (CEEMEA) regions. In Asia, growth improved in Taiwan and Thailand, but slowed in Malaysia and Singapore.

LONG-TERM CYCLE

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



Source: Putnam. Data as of February 28, 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.

Michael Atkin
Portfolio Manager
Investing since 1988
Sovereign debt,
global growth analysis

Albert Chan, CFA
Portfolio Manager
Interest-rate derivatives,
government debt, risk analysis

Onsel Emre, PhD
Analyst
Inflation, risk analysis,
global growth dynamics

Sterling Horne
Analyst
Politics and economics

Irina Solyanik, CFA
Analyst
Quantitative analysis,
growth forecasting

Izzet Yildiz, PhD
Analyst
Labor market analysis,
global growth dynamics

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