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THE MACRO REPORT | JULY 2018

Downside risks loom even larger

The outlook for global growth is favorable — albeit less synchronized — for the remainder of 2018. We are starting to see some convergence in growth rates — especially between the United States and the eurozone. The U.S. economy is poised to expand at a decent clip, buoyed by government spending and corporate investment. Across the Atlantic, there are some signs that the eurozone's weak economic spell is ending. The European Central Bank plans to end its bond purchase program by the end of 2018. But, the bank remains dovish on interest rates. However, our view of the United States and the global economy could change if the Federal Reserve overtightens and the trade spats escalate. Fed Chair Jerome Powell has expressed confidence about the U.S. economy, and signaled the march toward higher interest rates and balance sheet reductions would continue. The flattening Treasury yield curve — the narrowing in yields between longer-maturity and short-dated bonds — warrants greater attention from the Fed. In addition, the Trump administration's approach to trade, including escalating the dispute with China, has already rattled global financial markets and businesses.

THIS MONTH

Fed runs risk of overtightening

Trump, tariffs, and retaliation

Eurozone growing, ECB delaying

Fed runs risk of overtightening

The Fed steps up the pace of balance sheet reductions and interest-rate hikes in the second half of 2018.

The Fed meeting in June brought the expected rate hike and a mildly hawkish press conference. The June increase — the second this year — pushed the funds rate target to a range of 1.75% to 2.00%, and policymakers signaled they are on track to raise short-term rates at least twice more in 2018. We were a little surprised by the tone of the press conference. Fed Chair Jerome Powell described the state of the economy as "great" and the case for further rate hikes as "strong." The problem with this more direct mode of communication is that it is deeply misleading. The current state of the economy is essentially irrelevant to the choice about policy. The economy's position today reflects yesterday's policies.

A more hawkish Fed?

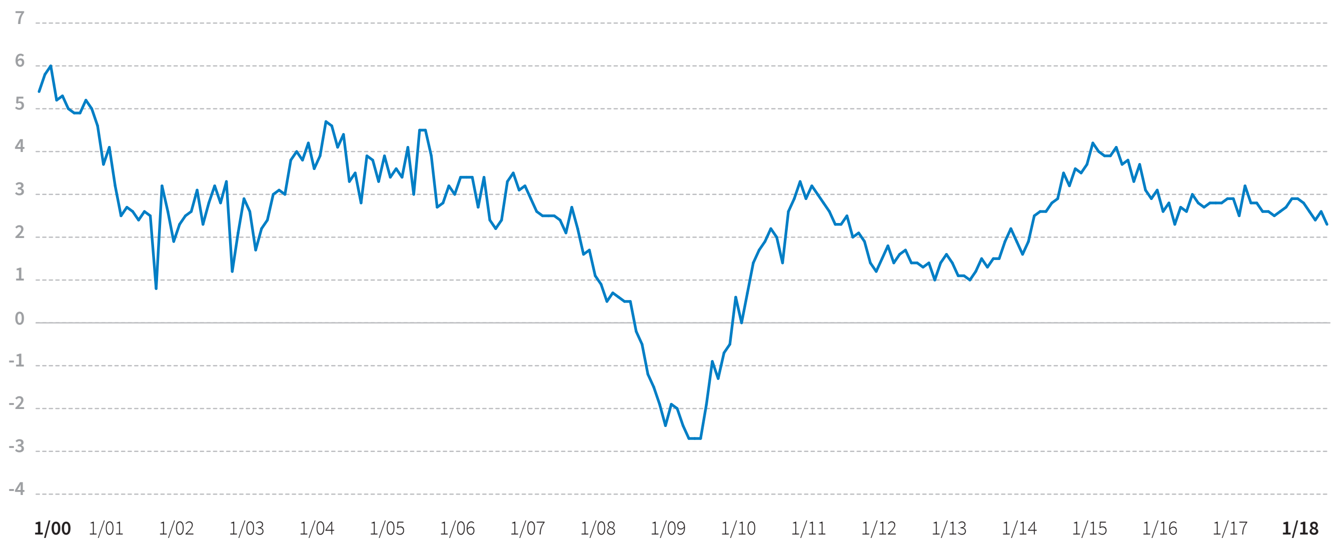
There is tightening in the pipeline as the Fed steps up the pace of balance sheet reductions in the second half of the year, coupled with additional Treasury borrowings (debt issuance) as the deficit widens and the government rebuilds cash balances. Short-term rates have kept pace with balance sheet reductions. It's not at all clear to us that the Fed is paying enough attention to these developments at the front end of the yield curve, which are certainly rippling through the economy and asset markets. This is not to say that the Fed is wrong to continue on the path of balance sheet reductions. Still, we think Powell was being a bit blasé in his recent comments.

The Fed's assets are slightly below 22% of gross domestic product (GDP) from a peak of just over 25% of GDP in the third quarter of 2014. The Fed increased monthly balance sheet reductions in April 2018, in the July-September quarter, and it will reach $30 billion a month in Treasuries and $20 billion a month in agency securities in October. This is the pace at which it will level off.

Could the stance of policy become too tight? We do think this is the risk now. Private sector balance sheets show a large accumulation of debt obligations, and rising debt service costs raise default risks. Inflationary pressures will remain modest. However, headline inflation will continue to reflect developments in the commodities markets, including rising oil prices. The Fed isn't too far from neutral now, and it has openly admitted it isn't certain what the neutral rate is, and how it may be changing. Several recent FOMC speakers have argued that a key reason for moving slowly on policy is to reduce the risk of doing too much when there's so much uncertainty. But while the approach may well lower the risk of overtightening, it doesn't

U.S. personal consumption expenditure lags

Personal Consumption Expenditures Index (% year-over-year)



Source: Bureau of Economic Analysis, as of May 2018.

Personal Consumption Expenditures (PCE) index: The PCE is the primary measure of consumer spending on goods and services in the U.S. economy. It accounts for about two thirds of domestic final spending.

eliminate it. An extra dose of caution would be appropriate at this stage of the cycle, rather than the exuberance about the "great" state of the economy that we got at the last Fed press conference.

Mixed signals

U.S. growth is expected to be a bit better in the second half of the year compared with the first half. The economy grew at an annual rate of 2.2% in the first quarter of 2018 due to weak consumer and business spending. Growth was below the 2.9% annualized rate in the fourth quarter of 2017. While it certainly seems Q2 will be a lot stronger than Q1, we shouldn't get carried away. The U.S. economy has expanded a little above 2% over the past few years. The latest fiscal stimulus and the rise in corporate investment will push growth higher.

There were positive and negative surprises in recent economic data. While manufacturing looked good, concerns are rising among manufacturers about trade issues, and regional activity indicators were mixed. The non-manufacturing sector is doing quite well, but consumption was sluggish. Spending growth remains quite subdued and has not picked up as much as many analysts expected.

In addition, the savings rate is starting to rise after the sharp decline in 2016 and 2017. If this continues, it will be hard for consumption growth to accelerate meaningfully. Household debt has been rising quite quickly, and housing is sluggish with no real momentum. So, while we acknowledge that Q2 was better than Q1, and while we continue to think H2 will be a bit better, if the trade war fears are not realized, the improvement as measured numerically will not be especially large.

Trump, tariffs, and retaliation

The real damage to the U.S. economy will come through trade retaliation since it will hurt business confidence and the financial markets.

In July, the United States and China imposed punitive tariffs on each other's imports. The European Union, Mexico, and Canada have similarly retaliated against President Trump's steel and aluminum tariffs. The trade war, should it escalate, is a clear risk to our outlook. Tariffs imposed by the United States on a stand-alone basis won't materially impact inflation, and while disruptive to specific supply chains, aren't expected to shift the GDP growth trajectory too much. The greater damage to the economy will come through retaliation, with an impact on business confidence and the financial markets. The critical question is: What is the Trump administration trying to achieve?

Tit for tat

Developments in the last few weeks are making us nervous. First, tit-for-tat retaliation has begun. Trading partners have been careful to match, and not to escalate, but they are retaliating. This is already raising worries among the business community. Second, the scope of concerns being raised by the administration is widening. Trump ordered a national security investigation of the auto industry, which would give him the power to impose the auto tariffs that he mentioned in his tweets. This would be a significant escalation and would certainly be damaging to the U.S. economy. The pipeline is primed for more tariffs. When tariffs against China went into effect on July 6, the Chinese swiftly retaliated.

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Third, evidence of disarray among the administration is increasingly worrying. The administration is clearly divided on trade, and the latest evidence of this comes in the bill that Trump has ordered to be drafted. The bill would give the president the authority to withdraw from the WTO and impose tariffs at will. The Fair and Reciprocal Tariff bill is an indication the bureaucracy is pushing back since Congress will have to review the bill.

Upping the ante

The president has the authority to act on trade, and he's using it. The only way the trade dispute with China would end quickly would be if the Chinese caved to Trump's demands. We are quite confident they will not. First, they don't know whether Trump is serious or not. If they believe the mainstream view — that Trump is all talk and no trousers — they don't have an incentive to offer much. Second, China has a lot at stake, including long-term goals for their economy. They will not give those up without a struggle and may not give them up at all.

So, the United States has to up the ante. Even if you believe this is only a game — a piece of theater — the threats have to escalate. Since the U.S. policymaking apparatus is barely functional, there is a clear risk that threats become badly implemented policies. China has demonstrated it has plenty of ammunition to deploy, both on U.S. imports and more broadly. The sharp decline in the yuan in late June was followed by a statement from the People's Bank of China (PBoC) that the currency was not being used as a trade weapon. The statement reminded everyone that the currency was available as a trade weapon, if necessary.

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Since the PBoC is not an independent entity with control over foreign exchange policy, President Xi Jinping can tell the central bank to do whatever he wants. Therefore, we should not interpret statements from the PBoC the way we would comments from the Fed, the European Central Bank, or the Bank of Japan. China can retaliate against U.S. multinationals operating in the country, threatening profit streams and giving equity markets something to worry about.

Downside risks appear

While the central outlook for the global economy remains reasonably benign, downside risks are beginning to appear. If the U.S. economy stays strong, risk of the Fed tightening too much looms large. If the trade conflict escalates, there is risk the economy will weaken. This is because business confidence and investment will be affected, and financial markets have shown their sensitivity to the possibility of trade conflict escalation.

Our central scenario calls for growth to continue, global divergence to partially reverse, central banks to remain cautious, and no eruption in the trade war. Under this scenario, we would expect rates to drift a little higher as cyclical factors push bond yields up, while global factors act to restrain this pressure. It would be an environment in which the dollar would stop appreciating — or perhaps depreciate — and risk assets, particularly emerging markets, would recover.

If these risks materialize, the second half of the year would be more like the first. Government bond yields would not move very much, and risky assets would come under renewed pressure. U.S. risky assets would probably continue to outperform risky assets overseas as the United States does have less overall exposure to trade.

Eurozone growing, ECB delaying

The region's growth is likely to pick up as economic indicators improve, but the trade spat with the United States continues to cast a shadow.

One of the big stories in the first half of 2018 was the deceleration of growth in the eurozone. However, the region's material downshift appears to be coming to an end. There are clear signs of stabilization in many growth indicators, including the services industry, and many indicators have turned up a little. Putnam's European Nowcast Index, which is quite sensitive to changes in momentum, has also edged up a reasonable amount. Economic growth had slowed to 0.4% in the first quarter — the weakest in six quarters — after expanding 0.7% at the end of 2017 as manufacturing eased and the euro strengthened.

Gathering trade clouds

There are certainly clouds. European business sentiment has deteriorated largely because of the risk that the trade conflict could become more serious. Eurozone economies are also feeling the effects of higher energy prices a little more than the United States. But domestic demand growth remains quite steady, consumer confidence is high, unemployment is falling, and consumers are in good shape. Wages are lagging the overall recovery a little, as they are in most of the world, but they are going up. And in Germany at least, there is a modest fiscal relaxation underway.

European business sentiment has deteriorated largely because of the risk that the trade conflict could become more serious.

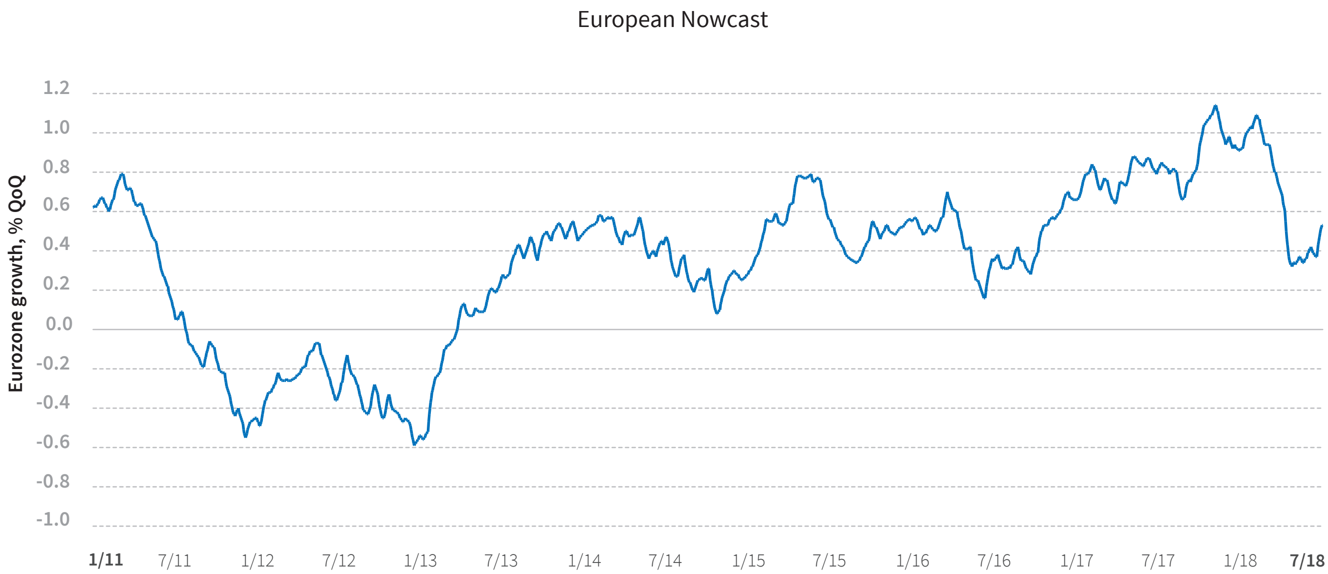
The domestic service sector is providing some offset to the concerns of the exporting manufacturers. Corporate cash flow is strong. If the trade conflict worsens, the eurozone will be affected. We consider this to be a serious risk. But it's not our central scenario. The central scenario envisions the eurozone will continue to grow at a reasonable pace.

A dovish stance on rates

The European Central Bank (ECB) in June decided to end its €2.6 trillion bond purchase program by the end of 2018. but ECB President Draghi sent dovish signals to the markets about the likely path of rate hikes once quantitative easing (QE) ends. The ECB indicated rates would remain unchanged "through the summer of 2019,"

Euro area's growth picks up

The Putnam European GDP Nowcast Index (% quarter-on-quarter)



Source: Putnam, as of July 2018.

We base our proprietary European GDP Nowcast on a tailored methodology that captures quarterly data releases for Europe's most essential growth characteristics. The mix of factors used may change over time as new indicators become available from data sources or if certain factors become more, or less, predictive of economic growth.

and Draghi delighted in the lack of specificity. Inflation hit 2% in June for the first time in more than a year, supported by higher oil prices. The pickup in the inflation rate was just above the ECB's target.

Draghi was anxious to balance one potentially hawkish message with another dovish one, and he has to manage the wide range of opinions on the ECB Governing Council. More recent commentary from the hawks, however, suggests they are not entirely happy with the dovish comments Draghi made about the likely timing of the first hike. They spent a long time getting a firm date for the end of QE, and they wanted to lay down a marker that they expect a rate hike to follow afterwards. It's hard to get too excited about all this. We have always known there are hawks at the ECB, and no one can be too confident now about what will happen in the fourth quarter of 2019.

The ECB indicated rates would remain unchanged "through the summer of 2019," and Draghi delighted in the lack of specificity.

But the hawks are a little unhappy about the weakness in the euro. Their recent comments are a useful reminder that there could be a faster pace of hikes in. While that is not a likely scenario, it's not out of the question. Our inflation forecast continues to suggest there is no reason for the ECB to rush on tightening policy.

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.

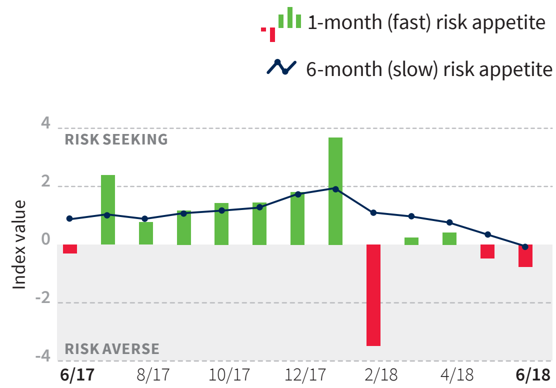
Risk appetite wanes

SHORT-TERM TREND

Investors avoided riskier assets on rates, trade jitters

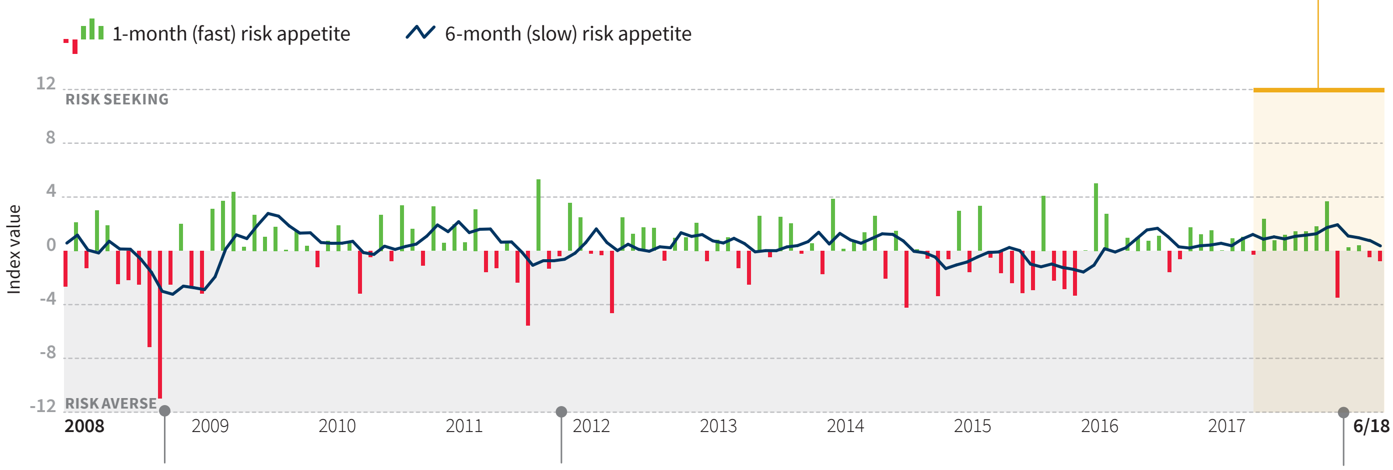
Risk ON OFF

- There was some variation in risk appetite with U.S. risky assets broadly outperforming
- Emerging market assets weakened as the United States raised interest rates
- Japan and eurozone bonds were relatively insulated, especially if they were currency hedged



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 '16–Jan '18
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 June 30, 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.

Economic growth stabilizes

SHORT-TERM TREND

Putnam's Global Nowcast suggests deceleration in global growth has ended

▲ 3.27%

Among G10 countries, New Zealand and Australian slowed while the eurozone picked up. The eurozone's Economic Sentiment Indicator held up despite trade risks. U.S. growth slowed due to weak industrial production. China's economy remained flat.

LONG-TERM CYCLE

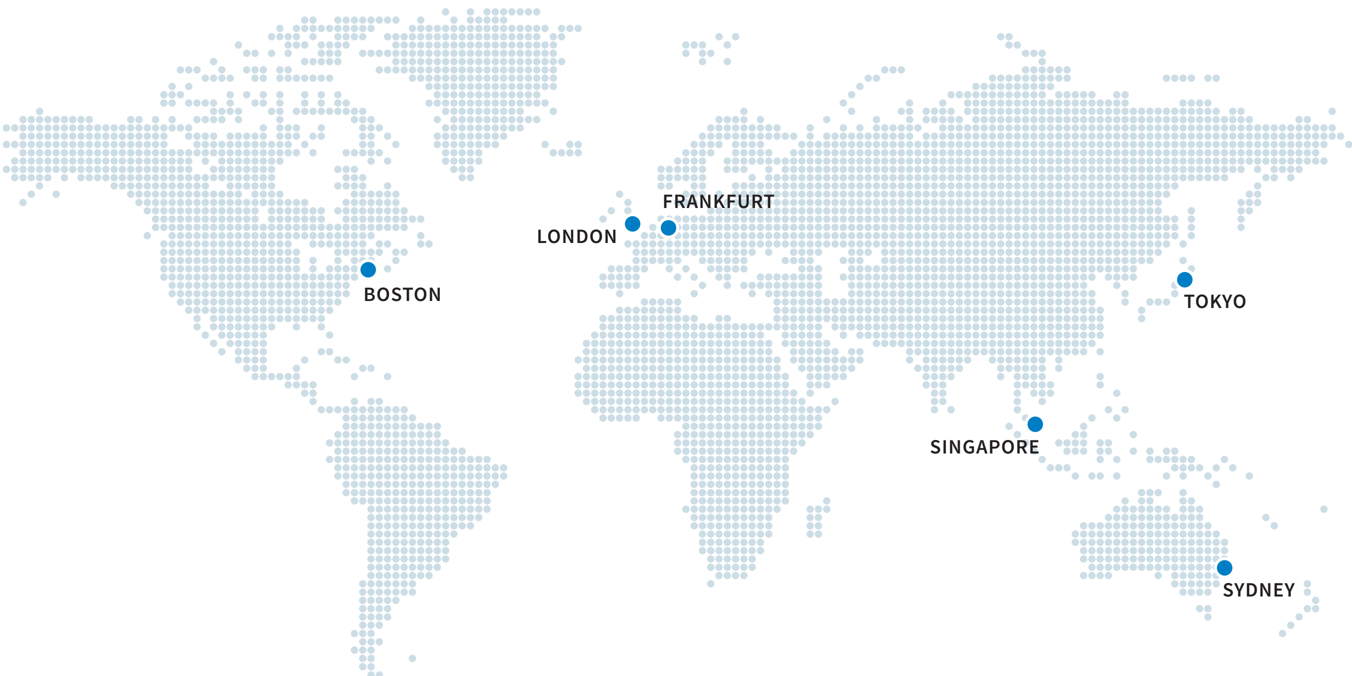
This six-year illustration captures GDP gyrations since the financial crisis.

Sept '12–Dec '13
Global growth swings dramatically, under pressure from sovereign debt crises and darkening global growth prospects amid fitful recoveries.

Jan '14–Oct '16
Global growth settles into a more subdued pattern of modestly disappointing results.

Nov '16 to Dec'17
More synchronous performance across global markets emerges to lift the trajectory of global growth.

Source: Putnam. Data as of June 30, 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.



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