THE MACRO REPORT | SEPTEMBER 2018

Market wild cards

The global economy is expected to enjoy relatively solid growth even as emerging markets tumble and the trade wars escalate. But rising real interest rates and a strong dollar are beginning to complicate the relationship with risky assets. Economic expansions may allow real rates to rise and risky assets to perform well. But rising rates that prompt global volatility or overeager central banks that raise rates more than warranted may cause risky assets to tumble. A strong U.S. economy has buoyed equity markets and prompted rate increases. Still, to the rest of the world, especially emerging markets, tightening dollar liquidity is an exogenous shock.

President Trump recently hailed the strength in U.S. consumer confidence. Strong growth, rising stock markets, and a plentiful job supply have lifted confidence levels among households. However, we are beginning to see a substantial gap between two confidence measures: The Conference Board and the University of Michigan. The disparity points to weaker-than-normal wage gains and spending despite a strong labor market. Over in the eurozone, inflation is beginning to reflect the rise in global energy and food prices. Core inflation is forecast to increase later this year and in early 2019 as wage growth improves.

THIS MONTH

Real rates and risky assets in tug-of-war

Clues on U.S. spending, confidence

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Real rates and risky assets in tug-of-war

The health of the global economy and swings in risky asset prices are intricately linked, and it is unlikely higher real rates will bode well for risky assets.

The relationship between real interest rates and risky asset prices is complicated. When an economy is doing well, like that of the United States, the return on capital rises, allowing real interest rates to rise and risky assets to perform well at the same time. But if the real rate rises because of global developments or an overeager central bank, then the rise in the real interest rate harms risky asset prices. A strong U.S. economy has allowed equity markets to do well and rates to rise. But to the rest of the world, especially emerging markets, the rise in the domestic cost of dollar liquidity is an exogenous shock that has harmed risky assets.

Some of the weakness in emerging markets can be explained by a few idiosyncratic developments, especially in Turkey, Argentina, and South Africa. These countries were vulnerable to a stronger dollar, the shift in global financing, and higher U.S. rates in the first half of 2018. The yield on the benchmark 10-year Treasury rose above 3.0% in May 2018 from 2.4% in early January. The dollar has increased between 6% and 8% during the same period, representing a tightening of dollar liquidity for economies dependent on global funding.

Can the current trends continue?

The question is whether this configuration of economic developments and risky asset performance can continue. We think it is highly unlikely, frankly. Still, the more difficult question is how convergence is likely to occur. Will emerging markets recover, or will the better-performing risky assets weaken? We discuss several channels in this context, and we will be following these issues over the coming weeks.

The most obvious channel of contagion is the financials sector. As Turkey's difficulties mounted, there were questions about European banks' exposures to local assets, including Turkish banks. When the European Central Bank (ECB) expressed some concern about European banks, the macro markets responded. None of this lasted very long.

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Global trade and tariffs

A second channel is through trade. Emerging markets as whole are weakening, but their weight in world GDP is small. China is the elephant in the room here; it matters for global growth, and a large number of global corporations derive a lot of their revenue from China. China is slowing, but only a little, and policymakers have responded. We don't expect stresses in emerging markets to cause a material global slowdown.

Within trade, we have the trade conflicts, which keep moving backward and forward. The theory that Trump on trade is all sound and fury and that the headlines are all that matter to him gained some credibility when the U.S. and Mexico announced their NAFTA breakthrough. We are also monitoring negotiations with Canada. There is clearly a risk that the whole thing will fall apart, but the plain fact is that the "new NAFTA" is pretty much the old NAFTA.

The role of central banks

Global central banks, including the Federal Reserve and ECB, also play a role in this configuration of rates and risky assets. Fed Chairman Jerome Powell defended the bank's policy of gradually raising the policy rate. He was a little dovish relative to his earlier comments about the "great" state of the U.S. economy. Meanwhile, the leading doves on the Federal Open Market Committee, James Bullard and Neel Kashkari, called for caution in tightening monetary policy. Overall, the Fed is looking to increases rates and seems to attach little, if any, importance to the stresses in emerging markets. The market expects rates to rise gradually.

As we discussed previously, there is risk the Fed will tighten more than warranted. The Fed's 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. The ECB also plays a part. Core eurozone inflation is expected to accelerate quite materially in the near future, and it's quite likely that the markets will price in an earlier move by the ECB. Finally, there is the channel of the U.S. economy itself. The economy had a good first half, supported by fiscal expansion and a modest recovery in private investment. We continue to monitor recession risk, which remains low.

Risks seem asymmetric

Our central scenario remains broadly unchanged. Decent growth may continue, but the degree of U.S. outperformance is likely to drop. We could manage to avoid a dramatic worsening in trade tensions. And even though the conflict between China and the United States could possibly get somewhat worse, it is unlikely to erupt into something deeply damaging. Under this scenario, global bonds yields will edge a little higher and emerging markets should be able to recover.

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But the risks still seem asymmetric. There is a good possibility the trade conflict will worsen more than we expect. And there is a chance that markets, or the ECB, will overreact to the increase in inflation that we forecast in the eurozone. The upside risk of the U.S. gathering strength and pulling up returns globally is certainly not impossible, but it does not seem very likely to us.

Clues on U.S. spending, confidence

The economy continues to look stable, but the gap between two consumer confidence measures points to weaker wage gains and spending.

President Trump recently noted the strength in consumer confidence. While confidence levels among households are high, there is a substantial gap between two widely recognized measures: The Conference Board and the University of Michigan's indices. The Conference Board's measure is heavily weighted toward the labor market and the measure of hard-to-find jobs and easy-to-find jobs. The Michigan measure has more variables and has more weight on prices, price expectations, and, by implication, real income perceptions. This gap between the two provides insight into the labor market: Job creation is strong, but wage gains are weaker than normal given the unemployment level. Headline inflation suggests that real incomes are doing worse than the pace of job creation may suggest.

The difference between these two confidence measures shows how households perceive the flatness of the Philips curve — the relationship between the rate of inflation and the unemployment rate. The Michigan survey tracks how households feel about possible purchases, including vehicles, homes, and durables. The homes measure has declined as house prices and interest rates increased. As a result, the housing market remains sluggish. The auto measure also declined and, not surprisingly, auto sales have weakened. And more recently, the durables measure fell. Consumers are pleased with the availability of jobs, but they are not so happy about trends in their real incomes.

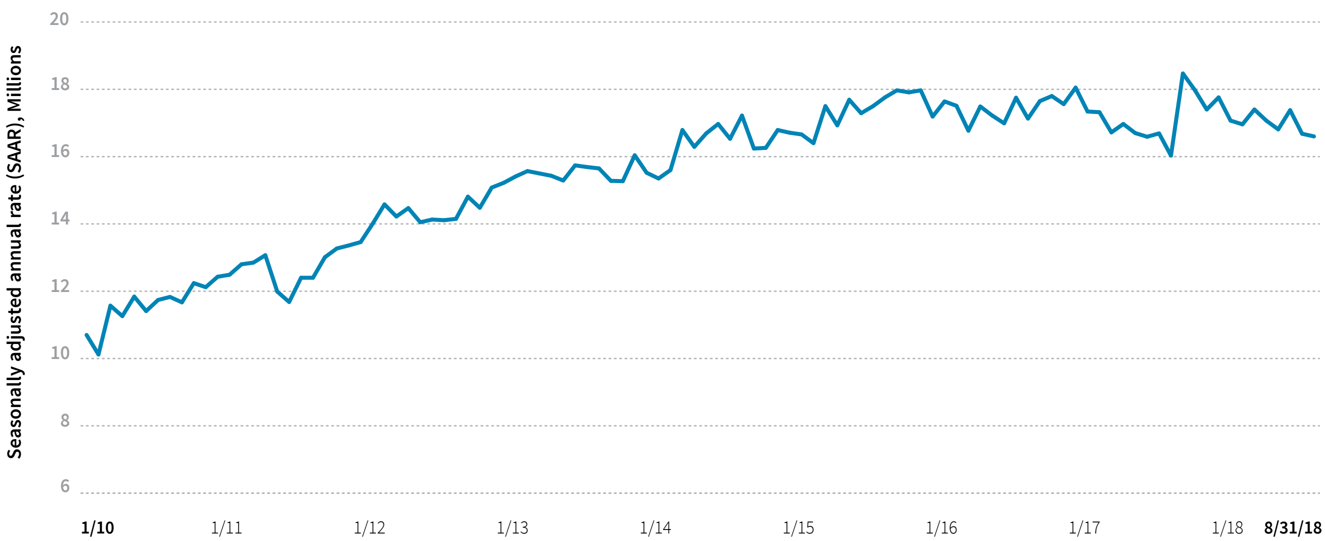
Manufacturing sheds workers

The Labor Department reported in early September that worker payrolls expanded by 201,000 in August and private-sector hourly wages grew 2.9% from a year earlier. The unemployment rate held at 3.9% for a second straight month. While the labor market report was broadly in line with expectations, there were two small variances.

First, not all sectors enjoyed job growth. The manufacturing sector's employment dipped for the first time in a while. While the August decline was small, we wonder if this is an effect of the ongoing trade and tariff disputes. Secondly, wages rose more than expected. The increase caused an immediate uptick in interest rates. This reflects the concerns we mentioned earlier; markets will be ready to price in a more aggressive path for the

U.S. light vehicle sales trend lower

(U.S. auto sales total annualized, SAAR)



Source: Ward Automotive Group, Bloomberg, as of August 2018.

Fed amid signs that wages are rising. Still, the wage gains were concentrated in one sector: trade. To start worrying about wage pressure, we would have to see evidence that wages are rising across the board, or at least in more sectors, especially since this sector — trade — has shown a lot of volatility in wages and employment levels in recent months.

State of the economy

Residential construction spending in the United States shows that the housing market is ceasing to make an important contribution to economic growth. Only spending on home renovations is still growing, reflecting the fact that households are no longer supporting an expansion in home construction. Because housing affordability is weak and incomes are not rising, people are spending more on renovating their existing homes.

The buoyancy of spending on renovation helps to explain retail employment, where home improvement stores are the sub-sector showing the fastest growth. Officially, it's building materials and garden supply stores; think Home Depot and Lowe's. It's also one sector where competition from internet retailing is not quite so intense. This reinforces the point that we are not yet seeing widespread pressure on wages.

We see risks as asymmetric. It is possible that we are at the early stages of a capex and productivity growth phase, which would allow economic growth and wage growth to be strong without inflation rising and without the Fed needing to shift to a more aggressive path. That is possible, but unlikely. It's more likely the economy is benefiting from fiscal stimulus, and that 2019 will bring either a slower pace of growth, as the stimulus disappears, or a more aggressive Fed, if growth stays strong.

ECB and the inflation game

Core inflation is forecast to increase over the coming months, and wage growth is picking up pace in Europe, prodding the ECB to keep a closer eye on monetary policy.

The summer heatwave in Europe could lead to higher inflation since food prices will rise because of crop damage. Core inflation, which strips out changes in energy and food prices, showed surprising weakness in August. The inflation measure fell to 1.0% in August from 1.1% in July. On closer inspection, however, the August data is a bit misleading; it may well have been an artifact of seasonality and the different ways in which national authorities and the European Union make adjustments.

The latest inflation forecast is important. While headline inflation will show the effects of global energy market developments and is beginning to show the effects of the hot summer on food prices, core inflation is forecast to rise later this year and in early 2019. We do not view this as a particularly controversial forecast because it largely reflects base effects and not a sustained rise in inflationary pressure. Still, it is a large increase. Core inflation is expected to increase as eurozone wage growth improves.

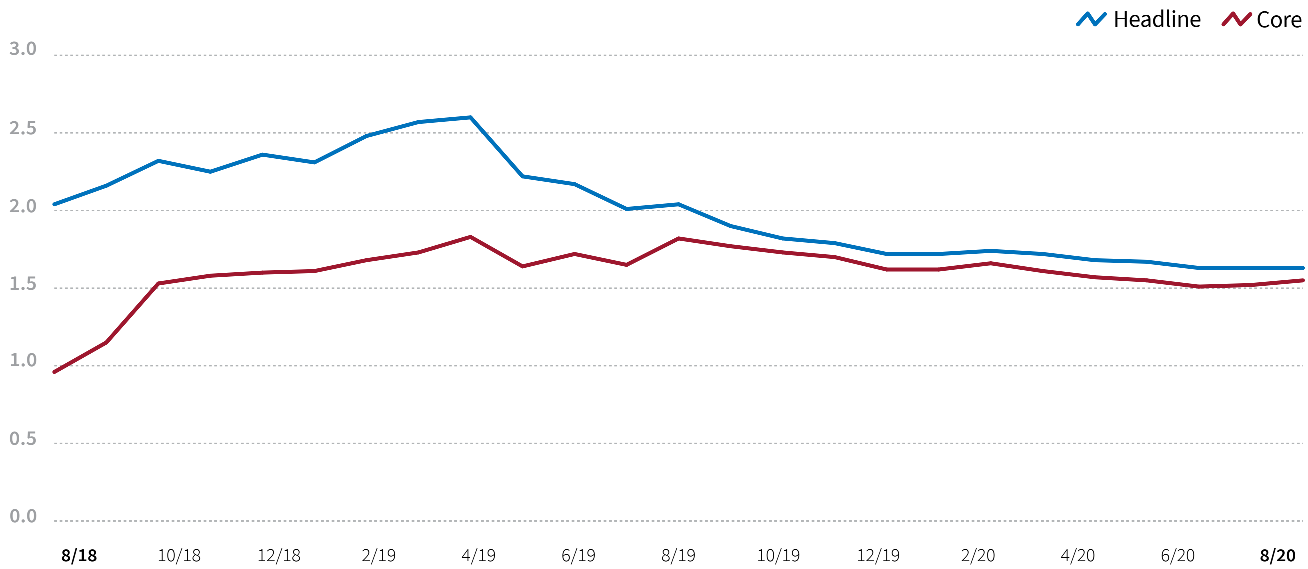
Unemployment in the eurozone continues to fall, and in the second quarter of 2018, negotiated pay rose 2.2% year on year, 0.7 points higher than a year ago. National data on compensation for employees showed wages rising about 2.4% in the second quarter from 2.0% in the first quarter. While we don't have the official eurozone figures, they are likely to be near the average for the national data. It's possible the rise in core inflation will generate some volatility in the interest-rate markets and could push global rates higher. This is not because it's a major inflection point in global inflation trends, but because expectations are so low.

The narrative that the eurozone is stuck in a Japanese-style low inflation equilibrium has too many adherents.

The narrative that the eurozone is stuck in a Japanese-style low inflation equilibrium has too many adherents. If the forecast is correct, it will force a lot of people to rethink their positions, pushing rates higher. The ECB is on the lookout for signals that inflation pressures are building as it prepares to end its bond-buying plan later this year. Restless hawks at the ECB will pounce on signs of rising inflation and wages.

Eurozone inflation picks up

Eurozone inflation forecast (% year-on-year)



Source: Putnam, as of August 2018.

New auto emissions standards

There is also a major change underway affecting the auto market in the eurozone. Beginning in September, new vehicles will need a new emissions certification. Vehicle sales surged in August as older models were discounted to clear dealers' showrooms. The new standards will boost estimates of retail sales and capex if the vehicles are purchased by corporations. The data for the summer months is likely to show a fall in auto production and a surge in auto demand. Since this is a large sector, the data will give a misleading picture of the economy. The underlying story is that the eurozone economy is growing at a steady pace, after the volatility of the first half, with decent growth in domestic demand.

Trade conflicts do matter

The ongoing trade conflicts between the United States and its major trading partners will have a negative impact, especially for Germany. Over the past couple of months, business confidence measures in Germany have moved up and down as concerns over tariffs and an escalation in the trade wars waxed and waned. Beyond confidence, we are starting to see evidence of real effects. The latest German factory orders showed an increase in domestic orders and a decline in foreign orders.

Germany, Europe's biggest economy, is a major global supplier of capital goods. The decline in external orders is an indication that global investment plans are being reconsidered in the light of the tariffs the Trump Administration are pursuing. German industrial production dropped 1.1% month on month in July 2018, missing consensus estimates while reflecting the auto issues and the trade tensions.

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.

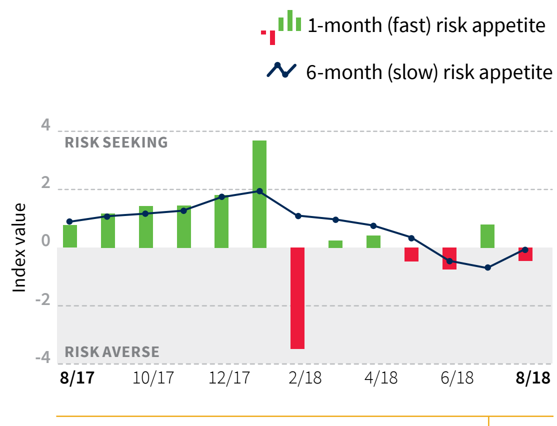
Risk appetite remains steady

SHORT-TERM TREND

August was a flat month in terms of appetite for riskier assets.

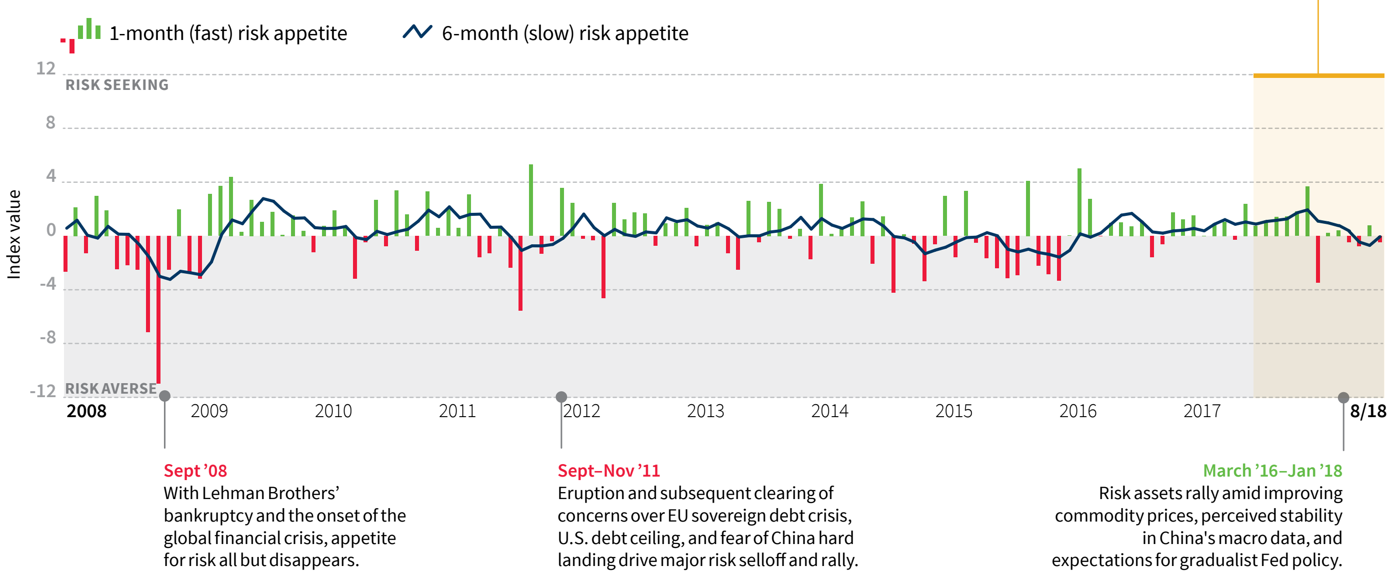
Risk ON OFF

- U.S. equities outperformed, while fixed-income securities had positive returns
- Emerging-market assets weakened amid higher rates and strong dollar.
- Commodities, excluding energy, declined but oil prices rose.



LONG-TERM CYCLE

This 10-year illustration captures the cyclicality of investors' appetite for risk.



Source: Putnam. Data as of August 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.

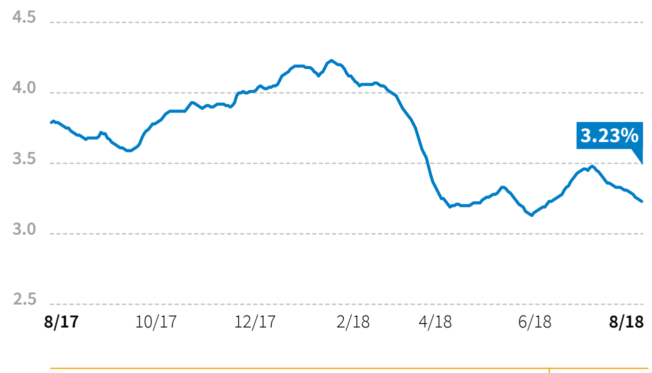
Global economic growth trends lower

SHORT-TERM TREND

Leading indicators suggest growth may ease further.

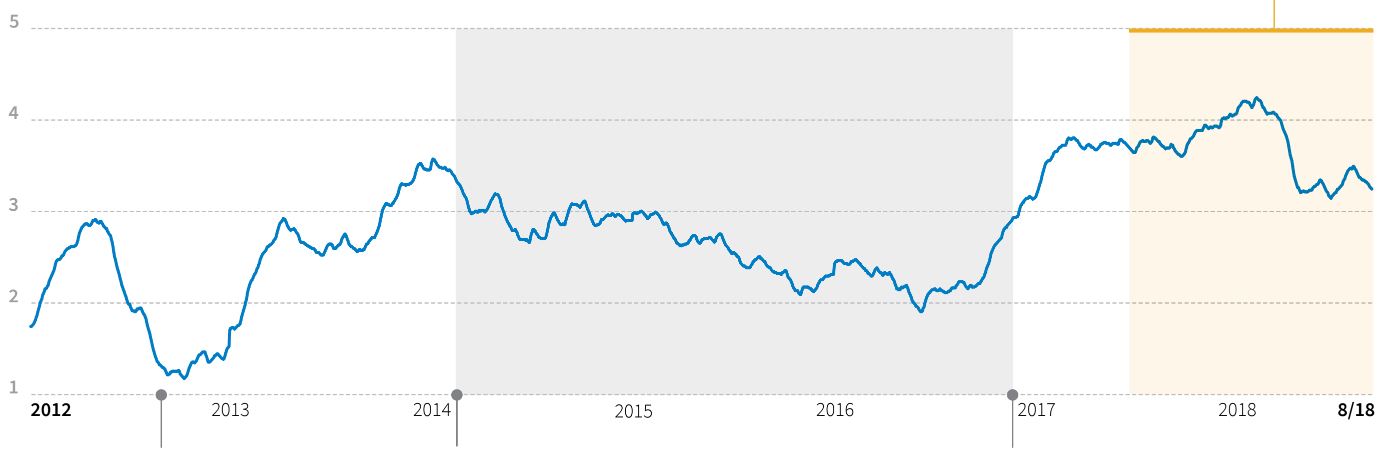
▲ 3.23%

Among G10 countries, the economies of the eurozone, Japan, and Australia slowed while the United Kingdom recovered slightly. Turkey's economy continued to decelerate, and South Africa was the second worst performer among the CEEMEA region. Growth in Latin America and Asia held steady. However, China's growth remained flat.



LONG-TERM CYCLE

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

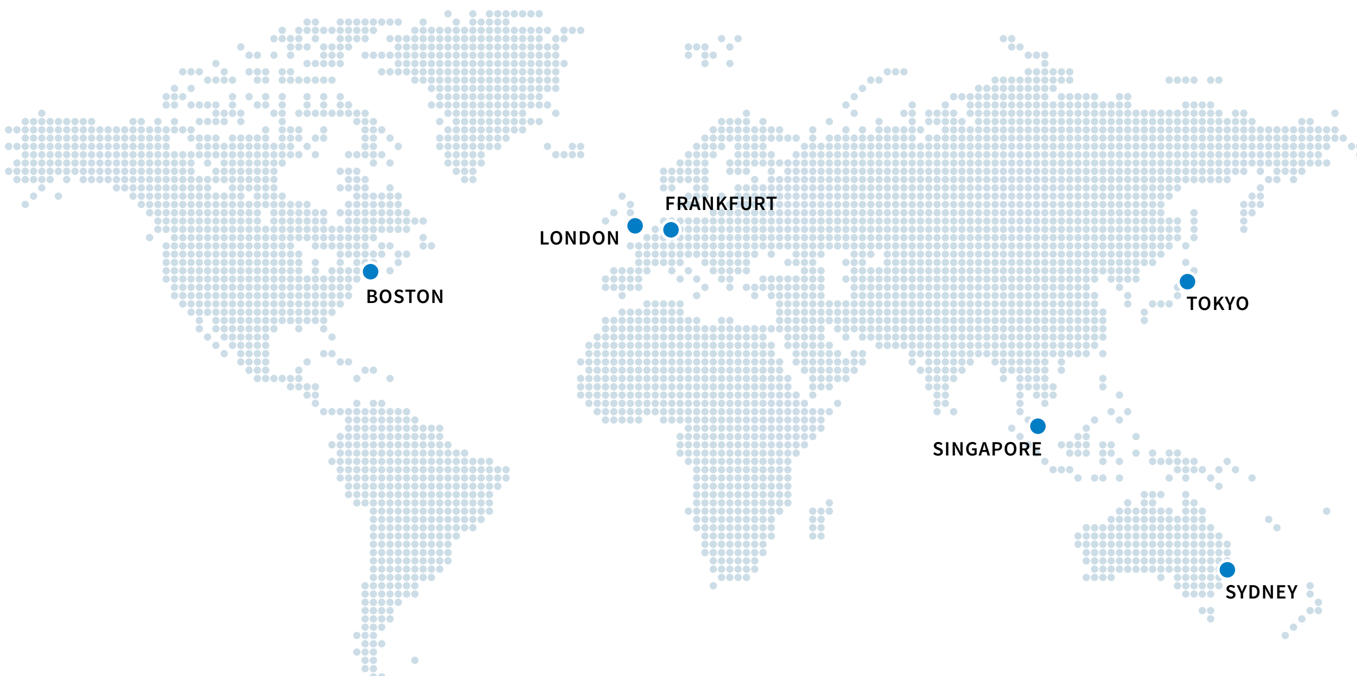


Sept '12–Dec '13
Global growth swings dramatically, under pressure from sovereign debt crises and darkening global growth prospects amid fitful recoveries.

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

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

Source: Putnam. Data as of September 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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United States
Putnam Investments
100 Federal Street
Boston, MA 02110
Phone: 617-292-1000

Germany
Putnam Investments Limited
Niederlassung Deutschland
Siemensstrasse 8, D-63263 Neu-Isenburg
Germany
Phone: +49 (0) 6102 56059 00

Australia
Putnam Investments Australia
Pty Limited
Level 13
167 Macquarie Street
Sydney, NSW 2000
Phone: +612 8083 9900

Japan
Putnam Investments Securities Co., Ltd.
Kamiyacho MT building
18th Floor
4-3-20 Toranomon, Minato-ku
Tokyo, 115-0001
Phone: +81 3 5404 5800

United Kingdom
16 St. James's Street
London, SW1A 1ER
Phone: +44 (0) 207 907 8200

Singapore
The Putnam Advisory Company, LLC
Singapore Branch
8 Marina View #28-01
Asia Square Tower 1
Singapore 018960

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

Putnam Investments | 100 Federal Street | Boston, MA 02110 | putnam.com

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