THE MACRO REPORT | OCTOBER 2018

Tweets and trade tensions

The outlook for global economic growth is easing because of trade tariffs, weakness in emerging markets, and rising oil prices. In the United States, growth will remain steady this year but is expected to slow in 2019 as the fiscal stimulus abates. The United States, Mexico, and Canada reached a new trade deal that is a lot like NAFTA but with a few upgrades and a few concessions. The United States-Mexico-Canada Agreement (USMCA) increases dairy exports from the United States to Canada and improves protections for workers in all three countries.

The story isn't so encouraging for China or Italy. The United States and China continue to be locked in a spiraling trade war. Policy makers in Beijing stepped up efforts to ease monetary policy to lift growth in a slowing economy as the trade conflict intensifies. China's hopes of negotiating a free trade pact with Canada or Mexico were dealt a setback by a provision in the USMCA that aims to forbid such deals with "non-market" countries. Meanwhile, Italy's ballooning debt levels and an unstable coalition government are weighing on the European Union (EU) and global markets.

THIS MONTH

NAFTA 2.0 emerges

China grapples with trade war

Italy's debt drama

NAFTA 2.0 emerges

The United States, Canada, and Mexico have reached a new NAFTA agreement, lifting months of uncertainty over the trade bloc.

Canada and the United States reached a new agreement in October on the North American Free Trade Agreement (NAFTA), joining Mexico in a previously agreed framework. The updated NAFTA trade pact was renamed the United States-Mexico-Canada Agreement (USMCA). There are a handful of things that are interesting about this new deal.

The United States gave ground on Canada's insistence on arbitration on disputes, effectively allowing Articles 19 and 20 of the original NAFTA to be carried over into the new deal, and the Canadians gave ground on dairy imports. The concession seems far greater on the U.S. side; one of the matters that was of great concern to the trade nationalists in the Trump Administration is the way the WTO and NAFTA undercut the authority of the U.S. courts. The United States gave way on a matter of principle here. In exchange, Canada agreed to open 3.60% of its dairy market to the United States. Under the Trans-Pacific Partnership (TPP), which Trump rejected as one of his first actions in office, the United States would have gained access to 3.25% of the Canadian market — an unremarkable difference of 0.35% .

Auto wages in dollars

The auto industry sections of the deal have generated a lot of comment. The "local content" rules were tightened, and it also required autoworkers to be paid in nominal U.S. dollars. This is to encourage jobs to remain in, or to return to, the United States, where the wage threshold is higher than the average wages of autoworkers in Mexico. The wage rule will become less binding each year. The cost of non-compliance with these "rules of origin" is small; in most cases, it will be a tariff of 2.5%. While it is not of zero consequence in the highly competitive U.S. auto market, the amount is hardly a king's ransom and is dwarfed by the kind of exchange rate volatility that global automakers are fully accustomed to. About 70% of vehicles made in Mexico would meet the new "local content" rules, and the rest would be subject to the WTO MFN tariff of 2.5% if imported into the United States.

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The final pact also addresses Trump's concern that the agreement provide a mechanism for renegotiation. The USMCA will run for 16 years with the condition that, after six years, the three countries can review the deal and either renegotiate or extend it for another 16 years. Since the deal will not take effect until 2019, the six-year period will go past a possible second Trump term.

One of the important and wholly legitimate arguments used to support the negotiations was the need to modernize NAFTA to take account of the changed economic circumstances in the intervening years. The new agreement covers some issues, notably intellectual property protection, that were not addressed in NAFTA. However, all this language seems to have been imported from the TPP. The United States participated in the negotiations over TPP before President Trump announced his decision to withdraw.

A currency provision aimed at China

The one really interesting and new part of the agreement concerns macroeconomic policies. The three countries agree to be bound by IMF policies on exchange-rate manipulation and to refrain from using currency intervention to produce competitive devaluation. They agreed to publish monthly FX reserves data and report on interventions in spot and forward markets, and to establish a committee that will review macroeconomic policies and practices. All this is quite new in a NAFTA context, although it does not go much beyond what is fairly routine for advanced country IMF members. It is also worth noting that costs of non-compliance with these requirements are trivially low. The agreement contains one other provision: It allows for the loss of some trade benefits if a member country reaches a free trade deal with a non-market economy. This is new and an interesting weapon to deploy against China.

Finally, it's worth remembering the political context of the negotiations, especially the final stretch of talks with Canada. Canada is the largest export market for 34 U.S. states, and its total imports from the United States are about double Chinese imports from the United States. The sheer range of companies and states that are involved in trade with Canada made it difficult for the administration to exclude Canada from the deal.

Awaiting congressional approval

The U.S. Congress has to ratify the trade deal. The timing is tricky because of the possibility that the Republicans will lose their majority in the House after the mid-term elections in November. In the past, there was a clear majority in Congress in favor of trade deals, with enough Democrats prepared to join Republicans to overcome opposition from the nationalist and protectionist wings of both parties. While we expect this to continue, there is the risk this coalition will be harder to form given the country's political climate.

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The USMCA is not going to have a major impact on the North American economy. An agreement does remove the downside risk of the United States withdrawing from NAFTA. But the changes that will be introduced when the USMCA takes effect are simply not large enough to change the trajectory of the North American economy in any meaningful way.

China grapples with trade tensions

Policy makers in Beijing continue to signal a willingness to react to signs of slowing economic growth and risks from trade tensions.

There are signs that growth in China's economy was slowing as policy makers encouraged deleveraging and the trade conflict with the United States escalated. In response, the government eased bank lending restrictions, helping to buoy the economy. The recent rise in industrial metal prices may be a sign that fiscal stimulus is beginning to support demand. While our estimates suggest an impact of around 1% of GDP, it is hardly disastrous given the economy is growing between 6% and 7%. The authorities have the policy tools and flexibility to offset shocks to the economy.

Still, an escalation in the China-U.S. trade conflict will have consequences for China. China's hopes of negotiating a free trade pact with Canada or Mexico was dealt a sharp setback by a provision in the new United States-Mexico-Canada Agreement (USMCA) that aims to forbid such deals with "non-market" countries. The United States and China are locked in a spiraling trade war, and even if there is an agreement, we expect tensions to escalate.

Little incentive for trade deal

As long as there is a chance that Trump only wants headlines, China has little incentive to offer anything substantive. Also, we are not very far along in this process. First, the Chinese have already floated a deal, with the support of Treasury Secretary Steven Mnuchin, and it was rejected. The idea that the Chinese can get away with buying more soybeans and liquefied natural gas from the United States is not passing muster with the administration. Moreover, the Trump administration has suggested that clearing the decks with the USMCA will allow a renewed focus on China.

Second, whatever the United States has done so far has not changed the cost-and-benefit calculus as Beijing weighs its options. If China wants to make a deal, they are more likely to respond if the costs of not conceding are raised. Some in the Trump administration are calling for more measures, and they seem to be winning the argument.

Complicated relations

Third, the inclusion of macroeconomic monitoring in the USMCA introduces another uncertainty in the China trade conflict. China is not an open market economy; capital does not move freely in and out due to capital controls. Also, capital does not move freely around China since the financial system is dominated by public sector banks in which credit decisions are very heavily influenced, if not entirely determined, by policy preferences set in Beijing.

China's growth trends lower

Source: Putnam, as of September 2018.

We base our proprietary China GDP Nowcast on a tailored methodology that captures quarterly data releases for China's most essential growth characteristics including purchasing managers' index data, industrial production, retail sales data, job market metrics, real estate activity indexes, sentiment indicators, and numerous other factors. 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.

All countries use a variety of techniques to push credit into favored sectors of the economy. But there is a dramatic difference in scale and scope between what China does and what happens in advanced economies. There was debate in the run-up to China's WTO accession in 2001 on whether it was appropriate to let a large non-market economy into the free world's trading system. Europe and Japan would probably join a U.S. campaign to address the distortions created by China's capital markets. Having put macro monitoring on the table with Canada and Mexico, the United States has opened a large area of potential tension with China.

> We don't expect an armed conflict, but China is sending signals that they are not prepared to roll over and accede to U.S. demands.

Fourth, the U.S.-China relationship is far more complicated and challenging than mere trade issues.

The geopolitical dimensions are becoming more important. North Korea is an example of how the two big players shuffle pawns around on the board. The past two weeks have brought more signs of stress. In the latest signal of the increasingly fraught ties, the Pentagon has canceled Defense Secretary James Mattis' visit to China later in October. And China has reacted with anger to the news that the United States is ready to approve a $330 million arms sale to neighboring Taiwan.

We don't expect an armed conflict, but China is sending signals that they are not prepared to roll over and accede to U.S. demands. Given the recent speech by Vice President Mike Pence accusing China of election interference, we can't discount the possibility that relations between the United States and China may worsen. For all these reasons, we remain concerned about the next steps in the trade conflict. Even though we may well end up with another benign agreement, we may not be able to get there without the conflict worsening. This is happening when global trade and manufacturing are already under some downward pressure.

Italy's debt drama

Recent developments in Italy, including unsustainable debt levels and an unstable coalition government, underline how fragile the eurozone remains.

We can't stop worrying about Italy's government bonds, or Buono del Tesoro Poliennale (BTP). Italy's debt levels are unsustainable, and the new government was elected on the back of expansive, and expensive, pledges to lower taxes and increase spending. These pledges are not consistent with the eurozone's fiscal rules. Italy's economic turmoil matters more to the rest of the world than the protracted Greece debt crisis; Italy has the third-largest sovereign debt market — after the United States and Japan — and its credit rating makes it only just eligible for inclusion in the Bloomberg Barclays Global Aggregate Bond Index. Given how much passive money is invested there, things could get ugly very fast if the ratings agencies take a dim view of Italy's fiscal future.

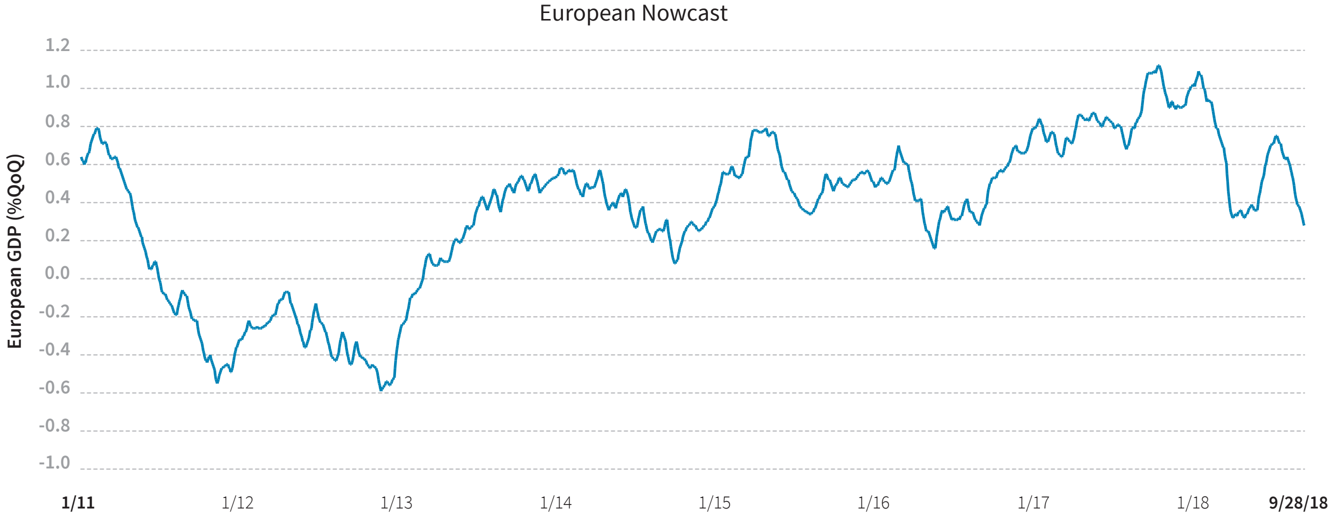
There are many actors on the stage right now. The EU has its rules, which can be interpreted with a certain flexibility, but the direction of policy is clear. Germany and its northern neighbors believe strongly in their approach, while President Emmanuel Macron's administration in France cannot afford to lose an argument with populists about spending. So, the EU will cut Italy some slack, but only a little.

Populism and the budget

The Italian government is an unstable coalition. The Five Star Movement (M5S) wants more spending but is pro-EU. La Liga wants lower taxes and a lower pension age, and it has some strongly eurosceptic elements. The balance of power between the two parties is changing. They ceded some authority to Prime Minister Giuseppe Conte and economy minister Giovanni Tria, who both agreed on a budget to stay on the right side of the EU. The markets and the ratings agencies are also key players. The ratings agencies matter because Italy's rating is close to the level at which we'd have to worry about index eligibility. Italy is rated BBB by Fitch and S&P, and Baa2 by Moody's. Since Moody's rating is on negative watch, two notch downgrades would mean exclusion from the Barclays Global Aggregate Bond Index. A large amount of capital would get reallocated away from BTPs if Italy lost its investment-grade rating.

The Italian government is an unstable coalition.

Eurozone GDP remains fragile



Source: Putnam, as of September 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.

The 2019 budget negotiations have reignited turmoil among Italy's political factions and the EU. There are differences in how to meet both a conservative fiscal target and EU rules. Tria had threatened to resign over a bigger fiscal deficit, the technocratic center has lost influence, and the eurosceptic wing of La Liga has gained power.

Trial balloons

Markets have been volatile as headlines have appeared about various deficit targets. The headlines are, in part, trial balloons designed to test the reaction of the markets and the EU. The politicians reacted pretty quickly when they saw Italian yields rise when some lax budget targets were published. The ratings agencies have maintained a calm distance, waiting for a reaction from the European Union. S&P is scheduled to update Italy's rating on October 26, and Moody's has indicated it will review the ratings around the end of October.

The headlines and the trial balloons have been about nominal deficits, and EU rules are also couched in these terms. These are a bit misleading since they are influenced by the cyclical position of the economy: Fiddle with the assumed growth rate, and you can do wonders with the headline deficit. It's useful to think in terms of the cyclically adjusted primary balance. While the "cyclical adjustment" can be controversial, it is, at least in theory, a better indicator of fiscal sustainability. The latest Italian proposals suggest a cyclically adjusted primary deficit of about 1.0% of GDP, whereas the trajectory the EU had agreed with the prior government would produce a surplus of 0.6% of GDP.

There's only so much that can be done by putting optimistic assumptions about growth and revenues into a budget. Italy will have to cave at some point or precipitate a crisis. But the eurosceptic Italians are probably playing a fairly long game and are reasonably content in this episode to be seen fighting the EU before conceding. They think this is the best way to build political strength at home. At some point, all of this could explode into a major crisis because the debt trajectory is simply unsustainable given the economic and political parameters. The endgame is not yet in 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 Index provides a framework for discussing investor preferences and can signal trend changes in broad market sentiment.

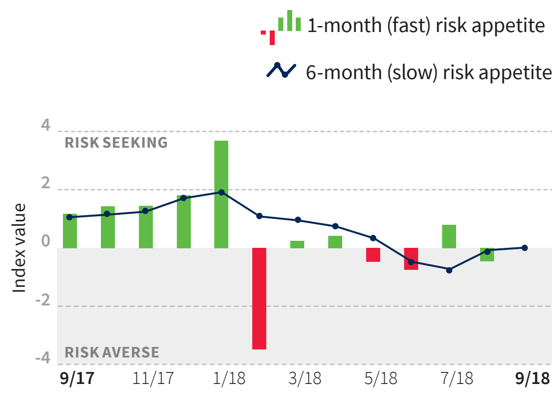
Risk appetite recovers

SHORT-TERM TREND

September saw improvements in appetite for risky assets.

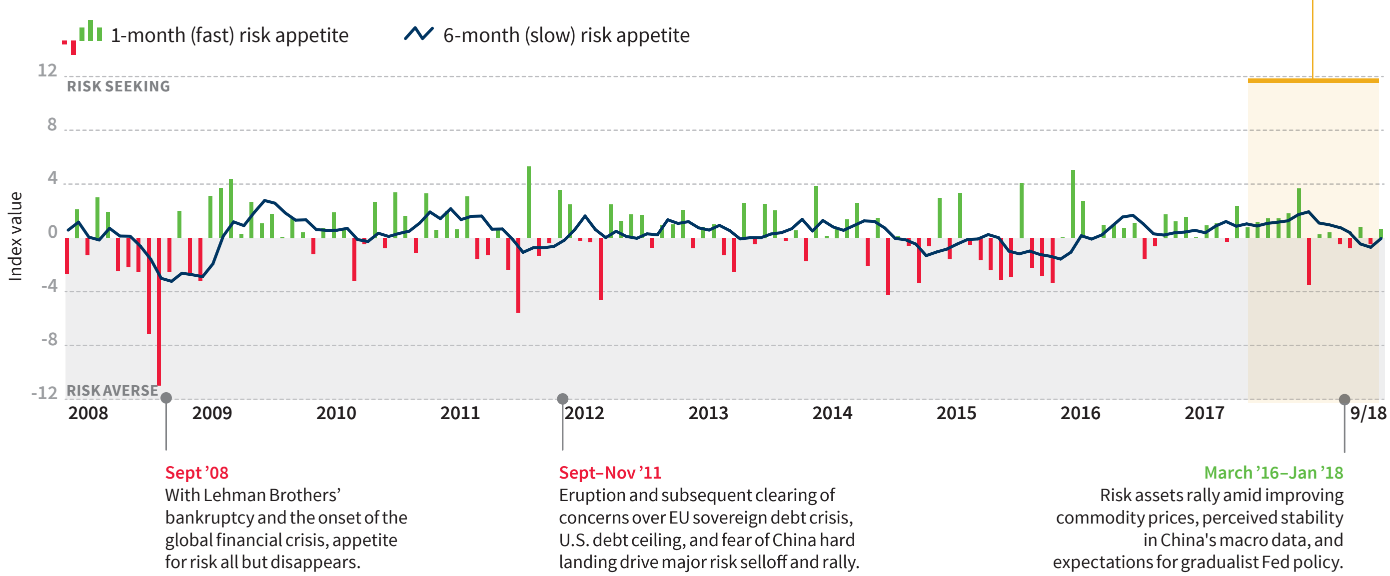
Risk ON OFF

- U.S. small-cap stocks underperformed
- Corporate credit, especially high-yield bonds, recovered
- International stocks gained, but emerging market equities declined
- The energy sector posted the biggest gains



LONG-TERM CYCLE

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



Source: Putnam. Data as of September 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.

Global economic growth trends lower

SHORT-TERM TREND

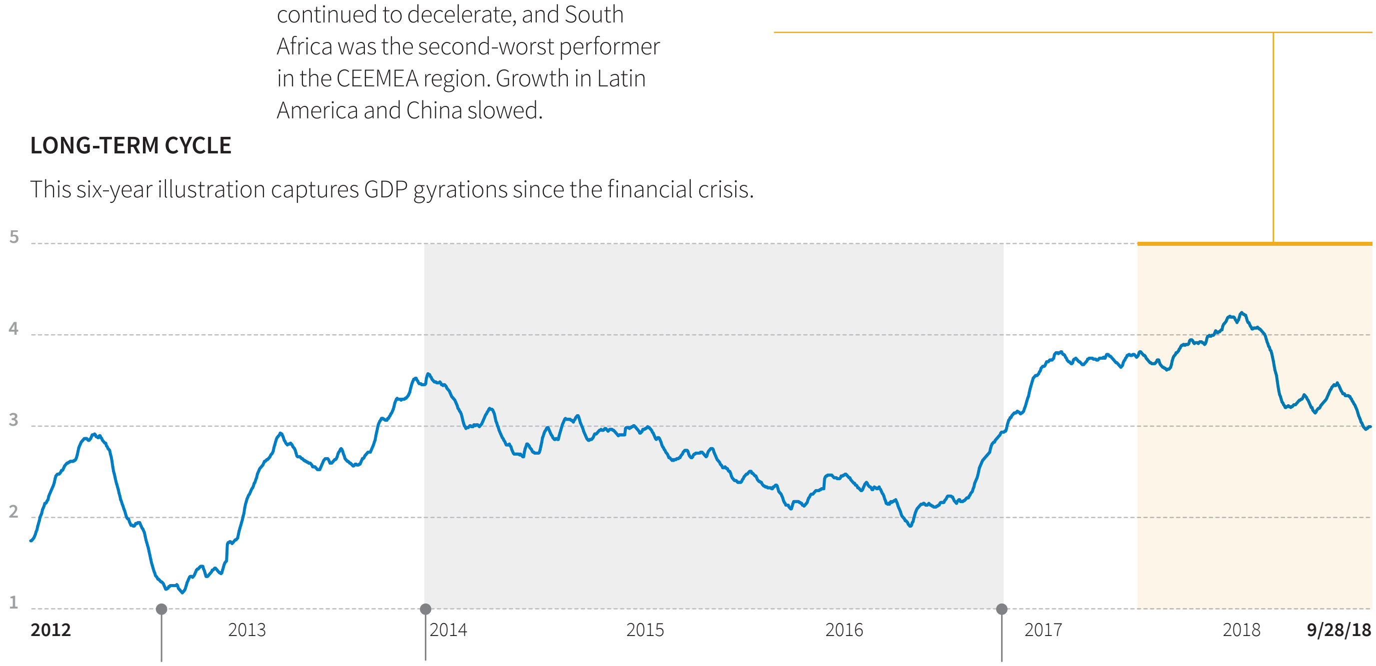
Global growth continues to slip amid China slowdown and weakness in exports.

▲ 2.98%

Among G10 countries, the eurozone economies and Canada slowed. The U.S. economy was little changed. In the eurozone, manufacturing, energy, and consumer confidence contributed negatively to growth. Turkey's economy continued to decelerate, and South Africa was the second-worst performer in the CEEMEA region. Growth in Latin America and China slowed.

LONG-TERM CYCLE

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



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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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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